Islamic Finance in the Global Economy

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A NOTE ON TRANSLITERATION AND DATES

Most scholarly works dealing with Islam use a transliteration system based on classical Arabic. In a book dealing with a variety of Islamic settings, most of them non-Arabic speaking, such transliteration would make no sense. Indeed, most common words dealing with the Islamic religion or tradition have their origin in the Arabic language but are written or pronounced differently. In a Turkish, Persian, Urdu or Malay setting, the purist system of transliteration would be confusing, if not outright misleading. This book will therefore dispense with diacritical marks and common symbols – apostrophes, horizontal strokes, etc. – (except in direct quotes using such characters), using instead a simplified system of transliteration. Thus, Koran will be used in preference to Qur'an and Shariah in preference to Shari'a. When possible confusion may arise (Malaysians use Syariyah for Shariah, Iranians use zarura for darura), both transliterations will be used.

All dates are based on the Gregorian calendar.

ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutes
ABC	Arab Banking Corporation
BCCI	Bank of Credit and Commerce International
BIMB	Bank Islam Malaysia Berhad
BIS	Bank for International Settlements
BMA	Bahrain Monetary Authority
BMI	Bank Muamalat Indonesia
BNL	Banca Nazionale del Lavoro
BNM	Bank Negara Malaysia
BSE	Bahrain Stock Exchange
CIA	Central Intelligence Agency
DIB	Dubai Islamic Bank
DJIM	Dow Jones Islamic Market Index
DMI	Dar Al-Maal Al-Islami
EBRD	European Bank for Reconstruction and Development
FBSEA	Foreign Bank Supervision and Enhancement Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FIBE	Faisal Islamic Bank of Egypt
FIS	Front Islamique du Salut (Islamic Salvation Front – Algeria)
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GNP	Gross National Product
HIFIP	Harvard Islamic Finance Information Program
IAIB	International Association of Islamic Banks
IAS	International Accountancy Standards
IBP	Islamic Banks' Portfolio
ICIEC	Islamic Corporation for the Insurance of Investment and Export Credit
ICMI	Association of Moslem Intellectuals (Indonesia)
ICRIE	International Center for Research in Islamic Economics
IDB	Islamic Development Bank
IDS	Islamic debt securities
IIBID	International Islamic Bank for Investment and Development
IICG	Islamic Investment Company of the Gulf
IIMM	Islamic Interbank Money Market
IKIM	Malaysian Institute of Islamic Understanding
IMF	International Monetary Fund

IMMCs	Islamic Money Management Companies
IRTI	Islamic Research and Training Institute
ITFO	Import Trade Financing Operations
IUT	Islamic unit trusts
LTCM	Long-Term Capital Management
LTTFS	Longer-Term Trade Financing Scheme
MESA	Middle Eastern Studies Association
MFI	Micro Finance Institutions
MUI	Indonesian Ulemas Council
NATO	North Atlantic Treaty Organisation
NEP	New Economic Policy (Malaysia)
NIEO	New International Economic Order
NIF	National Islamic Front
OBU	Offshore banking units
OEC	Organization of Economic Cooperation
OECD	Organization of Economic Cooperation and Development
OIC	Organization of the Islamic Conference
OPEC	Organization of Petroleum Exporting Countries
PERLs	principal exchange rate linked securities
PLS	profit-and-loss sharing
RAVs	repackaged asset vehicles
ROSCAs	Rotating Savings and Credit Associations
SAMA	Saudi Arabian Monetary Agency
VAR	value-at-risk
WTO	World Trade Organization

INTRODUCTION: ISLAMIC FINANCE IN THE GLOBAL ECONOMY

Islamic finance can no longer be dismissed as a passing fad or as an epiphenomenon of Islamic revivalism. Islamic financial institutions now operate in over 70 countries. Their assets have increased more than forty-fold since 1982 to exceed $200 billion. In 1996 and 1997, they have grown at respective annual rates of 24 and 26 per cent.[1] By certain (probably overly optimistic) estimates, up to half of the savings of the Islamic world may in the near future end up being managed by Islamic financial institutions.[2]

The first Islamic banks were created in the 1970s, at the time when the *aggiornamento* of Islamic doctrine on banking matters was taking shape. At the time, Islamic banks were typically commercial banks operating on an interest-free basis. Today, as a consequence of broad changes in the political–economic environment, a new generation of Islamic financial institutions, more diverse and innovative, is emerging as the doctrine is undergoing a new aggiornamento. Perhaps the most important development has been the growing integration of Islamic finance into the global economy. There is now a Dow Jones Islamic Market Index, which tracks 600 companies (from inside and outside the Muslim world) whose products and services do not violate Islamic law. Foreign institutions such as Citibank have established Islamic banking subsidiaries, and many conventional banks – in the Muslim world but also in the United States and Europe – are now offering 'Islamic products' that are sometimes aimed at non-Muslims.

Islamic finance is thus in many ways well suited to the global economy. This is all the more striking and paradoxical in that it is often said that Islam is incompatible with the 'new world order' that emerged with the end of the cold war.[3] In addition, how could a medieval economic system be relevant in a world of revolutionary, technology-driven global finance? And how could an interest-free system fit within the broader interest-based financial system?

One of the arguments of this book is that the globalization of finance has allowed Islamic finance to thrive and that there has been in recent years a fusion of sorts between Islamic and conventional banking. Whereas the traditional world of finance, dominated by commercial, interest-based

banking, could raise potentially troublesome theological issues, the new world of finance, characterized by the blurring of distinctions between commercial banking and other areas of finance, the downgrading of interest income, and financial innovation, has been rife with opportunities for Islamic financial institutions. Indeed, Islamic finance has driven financial modernization in many parts of the Muslim world.

A related argument is that the aggiornamento of the 1970s – the period when Islamic teachings were updated to create the first Islamic banks – is falling into obsolescence, and that a new aggiornamento, barely noticed in most writings on the subject, is emerging. The two updates have evolved under sharply different contexts. The first occurred at a time of Islamic assertiveness in the midst of a fleeting belief in a New International Economic Order (NIEO) that would favour the South at the expense of the North. It was dominated by oil-producing Arab states (primarily Saudi Arabia), with some input from Egypt and Pakistan. Since that period, the world of finance has undergone a dramatic transformation. The visions of banking or of the world economy that prevailed in the seventies are barely relevant today. The new aggiornamento is characterized by the increased multipolarity of the Islamic World, with emerging nations such as Malaysia playing a key role, and by vast transformations in international finance, driven by technological change, innovation, deregulation and globalization.

Perceptions of Islamic finance in the West cannot be separated from general perceptions of Islam, as a monolithic, unchanging and somewhat fossilized belief system. In reality, Islamic finance reflects the diversity of a 14-century-old, 1.2 billion strong religion spread over every continent. Islamic financial institutions come in all shapes and forms: banks and non-banks, large and small, specialized and diversified, traditional and innovative, national and multinational, successful and unsuccessful, prudent and reckless, strictly regulated and freewheeling, etc. Some are virtually identical to their conventional counterparts, while others are markedly different. Some are solely driven by religious considerations, others use religion as a way of sidestepping regulation, as a shield against government interference, as a tool for political change, or simply as a way of attracting customers. It should finally be noted that there are considerable disagreements among Islamic scholars as to which financial instruments are religiously acceptable.

Islamic finance is a complex and paradoxical phenomenon. A brief overview of a leading Islamic banking group suggests the limits of facile and sweeping generalizations: Dar Al-Maal Al-Islami (DMI), the largest transnational Islamic group, is headquartered in the Bahamas and operates primarily out of Geneva yet uses the language of the Islamic *umma*; although controlled by Prince Mohammed al-Faisal al-Saud (the second son of the late King Faisal, after whom the principal subsidiaries of

the group are named), the group does not operate a commercial bank in Saudi Arabia, a 'fundamentalist' country that has been instrumental in bringing about modern Islamic banking yet is one of the least hospitable countries to Islamic banks; to complicate things further, the DMI group has nonetheless been a significant conduit of Saudi money and influence throughout the Islamic world. In sum, the story of Islamic finance is a vastly complicated one, and cannot be captured without a full understanding of religion and finance, and also of history, politics, economics, business and culture.

The first part of the book provides background information on Islam and Finance (Chapters 1 to 3). It debunks common myths about Islam and Islamic finance, traces the historical evolution of Islamic economics and finance, as well as the mechanisms by which Homo Islamicus and Homo Economicus were reconciled, and considers religious injunctions as they pertain to finance. One of the underlying themes is the contrast between traditional interpretations with their emphasis on literalism and legalism, and modern ones, which are more adaptive and more likely to focus on the spirit, or the 'moral economy', of Islam.

The second part of the book introduces and describes the world of Islamic finance (Chapters 4 to 7). It traces the birth and evolution of modern Islamic finance and places it in its proper political and economic context. It accounts for the diversity of the industry by analyzing the ways different countries have introduced and dealt with Islamic finance, and by providing a typology of Islamic financial products.

The third part (Chapters 8 to 12) deals with the issues and challenges facing Islam from five vantage points: management, strategy and culture (how the practices of Islamic financial institutions differ from those of conventional ones; the strategies developed by Islamic financial institutions to expand their markets; the managerial problems encountered by Islamic financial institutions; the problem of the 'Islamic moral hazard'; the cultural barriers to the implementation of true Islamic financial systems); economics (the role of Islamic finance in mobilizing savings, allocating funds, and promoting development; Islamic capital markets; the macro-economic implications of Islamic finance); regulation (the regulatory issues raised, domestically and internationally, by Islamic finance; the impact of the regulatory norms of the global economy on Islamic institutions); politics (the connection between Islamic finance and domestic politics; Islam in the New World Order; the alleged ties of financial institutions to Islamic terrorism); and religion (the battles over religious interpretation in historical and comparative perspective).

Notes

1. Author's database.
2. In the words of Adnan Al-Bahar, Chairman of International Investor, an Islamic bank based in Kuwait: 'It is my belief that Islamic banking will be responsible for managing up to 50% of savings in the Islamic world in the coming five to 10 years.' *Los Angeles Times*, 11 August 1996.
3. Samuel Huntington, *The Clash of Civilizations and the Remaking of World Order*, New York: Simon and Schuster Touchstone 1997, p. 211.

1

ISLAMIC FINANCE IN THEORY AND PRACTICE

1.1 Defining Islamic Finance

What is Islamic finance? Definitions range from the very narrow (interest-free banking) to the very broad (financial operations conducted by Muslims). A useful definition is the following: Islamic financial institutions are those that are based, in their objectives and operations, on Koranic principles. They are thus set apart from 'conventional' institutions, which have no such preoccupations. This definition goes beyond simply equating Islamic finance with 'interest-free' banking. It allows to take into account operations that may or may not be interest-free, but are nonetheless imbued with certain Islamic principles: the avoidance of riba (in the broad sense of unjustified increase) and gharar (uncertainty, risk, speculation);[1] the focus on halal (religiously permissible) activities; and more generally the quest for justice, and other ethical and religious goals. Two aspects of Islamic finance must be singled out. First is the risk-sharing philosophy: the lender must share in the borrower's risk. Since fixed, predetermined interest rates guarantee a return to the lender and fall disproportionately on the borrower, they are seen as exploitative, socially unproductive and economically wasteful. The preferred mode of financing is profit-and-loss sharing (PLS). Second is the promotion of economic and social development through specific business practices and through zakat (almsgiving). Most but not all Islamic institutions have a Shariah board – a committee of religious advisers whose opinion is sought on the acceptability of new instruments, and which conduct a religious audit of the bank's activities – as well as other features[2] reflecting their religious status. In sum, the defining difference is that while 'conventional' finance usually seeks profit-maximization within a given regulatory framework, Islamic finance is also guided by other, religiously-inspired goals.[3]

No definition of Islamic finance is entirely satisfactory. To every general criterion – a financial institution owned by Muslims, catering to Muslims, supervised by a Shariah Board, belonging to the International Association of Islamic Banks (IAIB) etc. – one can find some significant exception. Indeed, even the criterion of self-identification – i.e., an Islamic institution

is one that calls itself Islamic – would leave out the Turkish Finance Houses or Saudi Arabia's Al-Rajhi Banking and Investment Company, which, for reasons explained later in the book, do not refer explicitly to their Islamic character. As for the principal focus on profit-and-loss sharing (PLS) activities, it remains more an ideal than a reality.

Islamic finance also involves more than banking. It includes mutual funds, securities firms, insurance companies and other non-banks. Where once – in the mid-seventies – Islamic banks were few in numbers and easily identifiable, the phenomenon has become quite amorphous with the proliferation of Islamic institutions and the blurring of the lines between traditional banking and other forms of finance. Another complicating factor is that a growing number of conventional financial institutions, inside and outside the Islamic world, have in recent years created Islamic subsidiaries or have been offering Islamic 'windows' or products in addition to conventional ones.

For the outside observer, the inevitable question is: how can a financial system operate without interest rates? The answer is that it can through the development of profit-and-loss sharing mechanisms, or through alternatives such as imposing fixed service charges or acting as buying agents for clients.

1.2 About Statistics and Performance Assessments

As of early 1999, Islamic financial institutions, including banks and non-banks (securities firms, mutual funds, insurance companies, etc.) were present in more than 70 countries. Their assets exceeded the $200 billion mark.[4] Based on a more limited definition that excludes non-banks and on 1996 statistics, the International Association of Islamic Banks (IAIB) puts the total assets of Islamic banks at $137 billion and their number at 166. IAIB statistics are shown in Table 1.1.

I have resisted the temptation to overload the book with detailed statistics, for the simple reason that they are often misleading, if not downright meaningless. This section is less about data than about the need to be careful with data. Indeed, detailed tables and charts are a staple of financial literature, often providing necessary 'padding' for skimpy analysis. Noting the endless quest of financial analysts for 'hard data', even when such data is fabricated, *The Economist* has titled an article on emerging markets statistics, 'The insatiable in pursuit of the unquantifiable'.[5]

Why are such markets so prone to misleading statistics? First is the quality of the raw statistics. Most emerging countries lack a tradition of transparency, strict accounting rules and rigorous reporting. Detailed statistics on Islamic finance typically contain caveats to the effect that there are unexplainable anomalies, inconsistency in accounting rules, and arbitrary shifts from one balance sheet item to another. Second is the

Table 1.1: Islamic Banks and Financial Institutions, Financial Highlights 1996

Region	*No. of banks*	*Capital*	*Total Assets*	*Deposits*	*Reserves*	*Net Profit*
South Asia	50 (31%)	$962 (13%)	$45,201 (33%)	%27,042 (27%)	1,849 (32%)	350 (21%)
Africa	35 (21%)	213 (3%)	1,951 (1%)	603 (1%)	418 (7%)	39 (2%)
Southeast Asia	30 (31%)	136 (13%)	3,801 (33%)	1,572 (27%)	1,943 (32%)	182 (21%)
Middle East	24 (14%)	4,060 (56%)	67,142 (49%)	54,288 (53%)	347 (6%)	373 (22%)
GCC[a]	19 (11%)	1,340 (18%)	18,084 (13%)	16,494 (16%)	1,095 (19%)	686 (41%)
Europe-America	8 (5%)	559 (8%)	952 (1%)	1,164 (1%)	93 (2%)	54 (3%)
TOTAL	**166**	**$7,271**	**$137,132**	**$101,162**	**$5,746**	**$1,684**

a Gulf Cooperation Council
Source: International Association of Islamic Banks

history, geography and evolution of Islamic finance. Whenever Islamic financial institutions start operating, they usually enjoy spectacular early growth, which can be explained by pent-up demand for Islamic products. With new competition and the inevitable growing pains, 'maturity' soon sets in. Depending on the selection of periods, one can 'prove' anything.

Also, a comprehensive census of financial institutions is now nearly impossible. In the early years of modern Islamic finance, most institutions were located in the Arab Middle East, owned by well-known investors, and belonging to the International Association of Islamic Banks (IAIB). In recent years, Islamic finance has spread to all parts of the world. Identification is all the more difficult since a majority of the new institutions do not belong to the IAIB, and many have sprouted in areas (such as Central Asian republics that were once part of the Soviet Union) where statistics are scant. In addition, much of the growth has occurred among non-banks (insurance companies, securities firms, credit unions, mutual funds, etc.) and other categories that do not appear in aggregate banking statistics.

Another complication is related to statistical anomalies. Sudden growth spurts in Islamic finance were often not caused by organic growth or even by the creation of new institutions, but by decisions by certain governments – Pakistan, Iran or the Sudan for example – to Islamicize their financial

systems. Overnight, the numbers and assets of Islamic financial institutions would jump, yet such increase would be meaningless in judging the success or failure of Islamic finance. Other statistical anomalies (the lack of consistent categorization of assets and liabilities; different calendar years; etc.) make comparisons between conventional and Islamic institutions – and even comparisons among Islamic banks – pointless. In many instances, gaps are found as institutions fail to publish their accounts for certain years, usually without explanation.[6] Despite efforts by the IAIB and other organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI),[7] there is still no agreement on accounting rules and procedures.[8] Finally, currency fluctuations at a time of global financial turmoil make international comparisons hazardous.

Perhaps the best illustration of the fact that analysts can 'torture the numbers till they confess' is the sharply different interpretations of the same sets of data. Perhaps the most widely 'analyzed' financial institution is the Faisal Islamic Bank of Egypt (FIBE). Yet even apparently careful monograph authors have been unable to explain what certain accounting categories included or what specific numbers meant.[9] Not surprisingly, while using the same sets of data, authors have arrived at different conclusions. One author has concluded that the experience was a great success.[10] Another that it was largely a failure.[11] A third has drawn a mixed picture.[12]

Leaving aside statistical vagaries, there is enormous diversity, even within a single country, among Islamic financial institutions. In Egypt, the three main Islamic banks have little in common. The Faisal Islamic Bank of Egypt is part of the principal, Saudi-controlled, global Islamic financial network. Its Egyptian shareholders include the country's political, economic and religious elite. The bank was created at the height of the infitah years and of the Saudi–Egyptian cooperation. Most of its activities are commercial and international in nature. In contrast, the International Islamic Bank for Investment and Development (IIBID) had no foreign investors and none of the political–economic connections that the FIBE enjoyed. Its activities were primarily domestic. As for the Nasser Social Bank, it is primarily concerned with social goals and works in close coordination with the government's social welfare agencies. Any broad generalization about Egyptian Islamic banks – let alone about Islamic banks in general – is thus likely to be meaningless.

Another mistake is to discount the context – political, economic, competitive – within which specific Islamic banks operate. In recent years, the most consistently profitable Middle Eastern bank has been Al-Rajhi Banking and Investment Company, Saudi Arabia's sole Islamic commercial bank. The reason is not that Islamic banks are inherently more profitable than conventional ones but simply that the bank enjoys a monopoly in a lucrative niche. Yet the temptation to generalize based on a sample of one

(at best, of a handful) remains strong. This book attempts to highlight both diversity and context.

1.3 The Literature

Quantity, not quality, is the defining feature of writings on Islamic economics, and more particularly on Islamic banking. The vast majority of the scholarship on Islamic finance belongs in the theological, apologetic or exegetic category. Unfortunately, very little is available that is of a comparative or political–economic nature, or that qualifies as rigorous, social-scientific research. As a result the bulk of the literature misses much of the big picture and glosses over important issues. Overall, scholarship is marred by four flaws: the ‘authorized’ nature of a significant portion of it; narrow geographic focus and lack of comparative analysis; reductionism (religious, financial and legal); and faulty assumptions about the relation between theory and practice.

1.3.1 The Problem of Authorized Literature

A preliminary step to assessing the scientific validity of any type of research – whether on the health effects of cigarette smoking or on the therapeutic value of a new drug – is to know who financed it. Research sponsors usually have an agenda and expect the research to produce specific conclusions. From that standpoint, much of the research on Islamic finance should be used with caution. Indeed, the sudden emergence in the 1970s of Islamic finance has created a pressing need: Islamic economics was in its infancy and modern Islamic banking was a new concept, so substantial research was necessary. Islamic financial institutions have been very generous in funding research institutes and promoting publications, conferences, symposia and seminars on Islamic finance. But the pressure instantly to generate a body of literature oriented toward certain conclusions explains both the vast output and its disappointing quality. Literally thousands of books, pamphlets and articles have been produced in the past few years on the subject, but very few rise to the level of serious, rigorous research. Over a dozen periodicals deal principally or even exclusively with Islamic finance. In addition, the business press – national, regional and international – carries frequent articles on the subject, much of which is of an ‘advertorial’ nature. Indeed, even in prestigious publications, one can find, annually and sometimes more often, the obligatory ‘sponsored section’ on Islamic finance. Such articles usually reprise the authorized discourse, reiterating the analysis and quoting the same numbers and the same ‘experts’. Overall, as in many areas of finance, it becomes hard for the researcher to separate independent investigation from public relations spin or in-house promotional literature.

1.3.2 The Geoeconomics of Islam

Because of patterns of academic specialization, studies of Islamic economics and finance tend to be slanted toward the Arab or Persian world, and most classifications are derived from political as opposed to economic factors. In the academic world, the study of Islam usually falls under the Middle Eastern studies category. Yet Arabs represent only about 20 per cent of the Islamic world, and the Arab, Turkish and Persian components of Islam taken together barely exceed one-third of Muslims worldwide. In the ranking of Muslim populations, Egypt, the most populous Arab country, comes only in eighth place. In his 1994 Middle Eastern Studies Association (MESA) Presidential Address, Rashid Khalidi acknowledged:

> [W]e in Middle East Studies have frequently failed to reach beyond our own area of interest to make connections with those studying other regions, including neighboring ones with characteristics and problems quite similar to those of the Middle East – like Central Asia, Africa, South Asia and the Mediterranean.[13]

This focus has led many analysts of Islamic finance to dismiss developments that have occurred outside the Arab Middle East.[14] In reality, significant innovation has occurred outside of the Middle East. In addition to pioneering countries such as Pakistan and Malaysia, there are Islamic experiments throughout the Islamic world, as well as within Islamic communities outside the Islamic world. By the same token, most Western perceptions of Islam are shaped by some of its most extreme political manifestations (the Iranian revolution, the Taliban, terrorism, etc.) that are representative neither of the mainstream of the religion nor of its economic aspects. The geoeconomics of Islam is indeed sharply different from its geopolitics. The largest Islamic communities are in Indonesia, Pakistan, Bangladesh and India, and not in the Middle Eastern core (see Table 1.2).

Table 1.2: Largest Islamic Populations

Country	Population Size
Indonesia	190 million
Pakistan	125 million
Bangladesh	120 million
India	100 million
Iran	62 million
Turkey	60 million
Nigeria	55 million
Egypt	50 million

Source: Yves Thoraval, *Dictionnaire de civilisation musulmane*, Paris: Larousse 1995, p. 123. Also United Nations Population Statistics.

Also, substantial Islamic middle classes have emerged in Asia, Africa, Europe and the United States. And Central Asian countries which were once part of the Soviet Union – Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan, Kyrgyzstan and Tajikistan – are, largely due to their oil, gas or other natural resources, poised to play a growing role in the world economy. In addition, certain countries or communities – one thinks of the sultanate of Brunei or of the Ismaili sect – possess great wealth while being politically insignificant. Any study of Islamic finance must acknowledge such geoeconomic diversity.

1.3.3 Religious, Financial and Legal Reductionism

Most writings on Islamic finance fall into one of three categories: theology, finance and law. Theological writings tend to assume an ahistorical world where timeless religious principles apply. Writings by finance experts – of the kind found in the international business press and in finance textbooks – on the other hand have little patience with the intricacies of religious tradition or the complex environment within which financial institutions operate.[15] The richest and most rigorous writings on Islam finance have been produced by legal scholars. The main flaw of such writings however is that they tend to define Islamic banking as 'modern banking based on medieval Islamic legal doctrines as interpreted, modified, and implemented by competent Islamic legal authorities'.[16] In other words, Islamic finance is all about law and it can only be understood by a return to usul el fiqh (principles of jurisprudence) and the rediscovery of the contracts of the classical age of Islam and their interpretation by the different schools of jurisprudence. Empirical studies of Islamic finance suggest that legalistic concerns are only one aspect, and probably not the most crucial one, of real world Islamic finance (see, for example, Chapters 6 and 7).

In sum, the literature on Islamic finance is deeply disappointing principally because it is neither empirical – based on the evidence – nor interdisciplinary – thus looking at all the facets of a complex and multidimensional phenomenon. The most learned volumes tend to wallow in endless hairsplitting, a proclivity common to jurists and theologians. The others tend to be shallow and faddish, focusing on the 'emerging market' of the day and on Islamic finance as either a hot or a fizzling new trend. Hence their catechism-like flavour, offering a simple – often simplistic – perspective on a complex topic.

1.3.4 Islamic Banking from Commitment to Implementation

One of the many paradoxes of Islamic finance is the contrast between the strong commitment of Islamist groups to the principle of Islamic banking and their lack of involvement in its implementation. On the one hand,

Islamicizing the financial system is usually at the very top of the demands of Islamist groups. One reason is that the injunction against riba is a distinctive feature of Islam. Yet the practical implementation of Islamic finance is seldom part of the realm of 'high politics', since Islamic movements seldom have a specific economic programme for putting their ideals to work. They tend to talk in generalities about implementing the Shariah, but have no proposals for making the Shariah induce economic prosperity or true social justice. This is due to the ambiguity of Islamic economic norms, making a consensus on actual policy prescriptions elusive,[17] and also to the fact that economic policy is usually secondary to political or cultural issues. As the Ayatollah Khomeini reportedly said, 'The revolution is about Islam, not about the price of melons'.[18]

Although theological and legalistic approaches assume that the Islamicization of finance proceeds according to a strict application of religious law and jurisprudence, the empirical evidence tells us otherwise (see Chapter 6). Economic issues, and in particular the specific implementation of financial legislation, do not rank very high on the agenda of Islamic groups, and most headline-grabbing Islamic groups – such as the FIS, Hezbollah or Hamas – have no clearly defined economic agenda.[19] On such matters as banking legislation, expediency is likely to prevail over 'Islamic correctness'. Typically, the wording of the legislation would conform to general principles but would be broad enough to accommodate a wide variety of interpretations. The general interest (maslaha) and overriding necessity (darura) – the need to achieve economic welfare and the requirements of a global economy – whether articulated or not, usually trump theological or legal concerns.

1.4 Perceptions, Labels and Classifications

1.4.1 Common Perceptions of Islam and Islamic Finance

Outside a small circle of practitioners, Islamic finance is little known. There are, however, within the general public as well as within the smaller communities of scholars and financiers, broadly shared perceptions about Islam in general (and sometimes even about Islamic finance).

In a recent American poll, over half the respondents described Islam as inherently anti-American, anti-Western, or supportive of terrorism – though only five per cent of those surveyed said they had much contact with Muslims personally.[20] Such attitudes are also pervasive among the policy elites. If we consider the influence of the likes of Francis Fukuyama or Samuel Huntington, we realize that lack of familiarity with Islam seldom deters people from making the kinds of sweeping pronouncements that soon become working assumptions in intellectual and policy debates.

When Fukuyama discusses the timeless conflict between Islam and liberalism,[21] or when Huntington states that '[i]n Islam, God is Caesar' or that '[t]he Koran and the Shariah constitute basic law for Islamic societies',[22] they are not only engaging in gross oversimplification. They are also making statements that do not stand up to rigorous historical or social–scientific analysis.[23]

In the abundant journalistic literature on Islam, the same stereotypes are usually expounded upon. Islamic finance is usually associated with political Islam.[24] A recent French book titled *The Fatwa against the West* devotes a few pages to Islamic finance, implying that the main if not the sole purpose of Islamic financial institutions is to finance terrorism.[25]

A recent survey of European and American bankers revealed that a majority were only vaguely aware of the existence of Islamic finance.[26] When asked what words and ideas the notion of Islamic finance evoked, the following were cited: 'monolithic', 'rigid', 'anti-Western', 'incompatible with modern finance', 'archaic', alongside 'oil money', 'BCCI', 'terrorism', 'Arab'. A few respondents did mention 'interest-free' and thus seemed aware of some of the distinctive features of Islamic finance. Within that category of respondents, two sets of attitudes were common. One was the view that Islamic financial institutions, being interest-free, cannot possibly work. (The interviewer would invariably find himself on the receiving end of a lecture on the role of interest rates in finance.) A variation on that theme – and one also leading to the conclusion of non-viability – was the equation of 'interest-free' with 'non-profit'. The other common set of attitudes was that Islamic financial institutions were no different from conventional ones, since interest, albeit under different names and guises, was used.[27]

Any religion that has survived for 14 centuries, and that has some 1.2 billion followers spread in every part of the globe, must have some measure of flexibility and diversity. Any such religion should be resistant to broad-brush generalizations. Statements to the effect that 'Islam says …', 'Muslims believe …', must include significant qualifiers and caveats. Yet Islam is usually represented in terms of a monolithic umma (community of believers) and a fossilized belief system that has not changed since the seventh century. In that respect, Islam is unique: although every major religion has numerous, often contradictory, strands – intolerant and inclusive, moderate and radical, pietistic and political, obscurantist and progressive, peaceful and violent, mystical and worldly, etc. – not to mention its share of objectionable features and lunatic fringes, only Islam is likely to be systematically associated with its most extreme manifestations. An implicit assumption is that only the most backward form of the religion represents true Islam. John Esposito has observed that 'non-Muslim scholars sound more like mullahs':

> When faced with new interpretations or applications of Islam, they often critique them from the vantage point of traditional belief and practice. On the one hand, Islam is regarded as fixed, and Muslims are seen as too reluctant to accept change. On the other hand, when change occurs, it is dismissed as unorthodox, sheer opportunism, an excuse for adopting that which is outside Islam.[28]

In the late 1990s, the emblematic figures of Islam in the Western mind are radical fundamentalists – the likes of Afghan Taliban or terrorist figures such as Usama bin Laden – who by their statements and positions 'realize the wildest fantasies of Orientalism'.[29] Sami Zubeida has noted the convergence 'between the adherents of the Islamist movements and Westerners writing in the Orientalist tradition. Each postulates a cultural essence which underlies and unifies Islamic history and distinguishes it from an equally reductionist notion of the West.'[30]

One of the more misleading generalizations is that Islam, unlike other religions, is a 'complete way of life'. For one thing, this could be said of any religion, since most enjoin virtuous behaviour in everyday life. The implication is that the demands of Islam are not compatible with the requirements of modern life. Yet in many ways, Islam has less 'structure' than other religions. What all Muslims share is a core of basic principles, the so-called 'five pillars' of the faith.[31] Islamic clerics do not administer religious sacraments. They are more akin to religious/legal scholars who interpret the scriptures. Unlike other religions, the conversion process is simple: it consists in a witnessed profession of faith (shahada). Islam has no baptism or other initiation ceremony. Muslims do not belong to congregations. Mosques are open to all and do not maintain membership rolls. Islam also teaches that each person has a direct relationship with God and that no intermediary is needed. Many of the traditions associated in the Western mind with Islam (the use of the veil for women, for example) are not mandated by religion but can be explained either in terms of local customs or as 'fundamentalist' reinterpretation of Islam.

The association of Islam with 'a total way of life' leads to two common assertions with regard to politics and economics. One is that Islam prescribes very specific norms. The other is that Islam is inherently and primarily political. In reality, as will be seen throughout this book, Islamic norms on political and economic matters are broad and somewhat ambiguous, thus accommodating a wide variety of interpretations.[32] Many Islamic scholars actually draw a distinction between 'political Islam' and 'enlightened Islam'.[33] As for the propagation of the Islamic faith, most of it is non-political – though the casual Western observer would not know it. Indeed, a number of students of Islam have noted that extremist political organizations – such as Hezbollah or Islamic Jihad – whose numbers run in the thousands or sometimes in the hundreds, receive wide coverage, while apolitical organizations of a pietistic or missionary nature – such as Jamaat

Tabligh – have millions of members yet are totally ignored by the media and the most widely quoted 'experts' on Islam.[34]

1.4.2 The Diversity of Islam

Despite the prevailing clichés, a striking feature of Islam is its sheer diversity. Muslims constitute a majority of the population in some 50 countries in Africa, the Middle East, Central, South and Southeast Asia. They are a minority, often a fast-growing one, in most parts of the world, including Western and Eastern Europe, Russia, the Americas and Australia. The diversity is also religious, racial, ethnic, political, social, economic and cultural. Despite the language of a unified umma, Islam is fragmented and decentralized, with no 'clergy' and no centralized, 'Vatican-like' Church. Only a few countries – most prominently Iran – have a tradition of autonomous and hierarchically-structured clergy.

Most people are familiar with the Sunni–Shia divide. But there is a far greater diversity of religious groups, beliefs and practices. Differences can be attributed to religious schisms, but more commonly to different historical paths as well as exposure to outside influences. In certain areas, such as what is now Saudi Arabia, there is a tradition of religious homogeneity (with the exception of a small Shia minority). Non-Muslim presence has been virtually absent and outside influence scant (the Ottoman influence was nominal and significant contacts with the West started only with World War I). Being the birthplace of Islam is also of course a crucial element in the country's identity and religious beliefs and practices. But Saudi Arabia is a minority of the Arab world (18 million out of 200 million), which is itself a minority of the Islamic world (200 million out of about 1.2 billion).

In the Islamic world at large there are numerous traditions – Persian, Turkic, Indo-Pakistani, Indonesian, Malay, etc. – that have little in common with the experience of the Arabian Peninsula. The nature of the Islamic beliefs and traditions are shaped by numerous factors ranging from when and how the area was Islamicized to the nature of pre-existing beliefs and institutions, to subsequent outside influences. In Indonesia and Malaysia, the Islamicization process occurred primarily around the fifteenth century. The local population was converted by merchants, not conquering armies. The brand of Islam that took root was mostly influenced by sufism. It thus had a mystical foundation as opposed to the theological and literalist bias that could be found in other parts of the Islamic world. It was also cut off, for geographic and historical reasons, from the great Islamic empires. As a result, the brand of Islam that developed was idiosyncratic as well as syncretic, integrating a wide array of local and regional influences.[35]

In Eastern Europe and the former Soviet Union, Islam was long suppressed or ignored, only to re-emerge in a context of turmoil and foreign encroachments. In the Balkans, some eight million Muslims form today a

distant legacy of centuries of Ottoman rule. In the former Yugoslavia, much of Bosnia-Herzegovina, Macedonia and the Kosovo province are Muslim. So are the majority of Albanians and a minority of Bulgarians. 'Ethnic cleansing' by Serb forces resulted in NATO bombings over Bosnia-Herzegovina (1995) and in an all-out war against Serbia over Kosovo (1999). Within the Russian Federation, the Muslim Chechens, a long-persecuted minority, have engaged in a full war of secession against the Russian army. In the Caucasus, Muslim Azerbaijanis have a long historical enmity with Christian Armenians. In Central Asia, Kazakhstan, Turkmenistan, Uzbekistan, Kyrgyzstan and Tajikistan have either a majority or a plurality of Muslims. What all of these groups have in common is that they lived for decades under a political system that was anti-religious. In some cases such as Albania, Communist governments engaged in aggressive religious suppression. In others, such as in the former Soviet Union, cultural and linguistic traditions persisted, but the role of religion was considerably reduced. In a post-Communist era, religion surfaced with a vengeance. Many communities which were only nominally Islamic found in Islam an essential component of a long-suppressed identity, and a number of Islamic countries – such as Turkey, Iran and Saudi Arabia – have been attempting, for a combination of political, economic and religious reasons, to export their own brand of Islam to that region.

Another phenomenon is the increased presence (mostly through recent immigration) of Muslims in non-Muslim lands. In the United States, Islam is expected to become in a few years the second largest religion. One-third of its five million adherents are black Americans. The others are mostly of Arab, Persian or Pakistani–Indian ancestry.[36] Western Europe is home to some 14 million Muslims, although national origins, governmental policies and degrees of assimilation differ greatly.[37] French Muslims are primarily from Northern Africa – Algeria, Tunisia and Morocco – and are subjected to a specific mode of individual integration based on the tradition of 'laïcité'. In Germany, Muslims are usually from Turkey, and are subjected to different rules and practices. Their status, and that of their descendants, is that of 'guest workers' (making them ineligible for German citizenship). In the United Kingdom, Muslims are overwhelmingly from the Indian subcontinent and are integrated in the British society 'as a group and not as individuals'.[38]

For all these reasons, one can identify a very broad range of Islamic beliefs and practices, that is in fact similar to what could be found in other religions such as Hinduism, Christianity and Judaism. At one end of the spectrum, there are strict Muslims who would like religion to extend to all aspects of political and economic life.[39] Even within that category though, the understanding of religion and its tenets varies greatly, and there are significant disagreements as to how (and whether) Islamicization can be achieved.[40] At the other end of the spectrum, there are 'nominal Muslims'

or 'sociological Muslims' who do not usually practise their religion and know little about it. Many Muslims around the world today have confined religion to the private domain of personal laws and separated it from economic and socio-political activities. It would thus be more accurate to talk about 'Islams' rather than 'Islam'. In the words of Aziz Al-Azmeh, 'Islam is not a generic essence, but a nominal entity that conjoins, by means of a name, a variety of societies, cultures, histories and polities'.[41]

1.4.3 'Fundamentalism' and Other Labels

The dilemma of the researcher is that for purposes of description and comparison, labels are necessary, yet most of these labels belong to Western categories and perceptions that do not always fit Islamic realities. Labels used to describe different types of Islam – Islamism, fundamentalism, neo-fundamentalism, revivalism, modernism, traditionalism, liberalism, conservatism, Islamic totalism, establishment Islam, populist Islam, etc. – are to varying extents misleading.[42] Perhaps the most misleading of all, and the most overused, is the 'fundamentalist' label. The word originated in connection with American Protestantism, signifying a literal reading of the Bible. ('Intégrisme', its French counterpart, was used to describe Catholic traditionalism.) In the Western mind, the word 'conjures up images of mobs shouting death to America, embassies in flames, assassins and hijackers threatening innocent lives, hands lopped off, and women oppressed'.[43] In all too many instances, fundamentalism is used interchangeably with Islam and with radical extremism.

The 'fundamentalist' label, which is supposed to have both religious and political overtones, has been applied to the governments of Libya, Saudi Arabia, Pakistan, Iran, and the Sudan, and to virtually every Islamist group and organization. In terms of both religion (the brand of Islam they follow, the role of clerics in the political leadership) and politics (the nature of political institutions, the ties with the West, the degree to which they want to export their institutions), the countries cited are sharply different. As for 'fundamentalist' parties, they come in all shapes and forms. One study estimated that, as of the early 1990s, there were 175 Islamist groups (three-quarters of them 'militant' or 'radical') in the Middle East.[44] Another study found 45 'Islamist' groups in Egypt alone.[45]

The confusion stems from the fact that the word can have different meanings. Ian Lustick's definition is that of an uncompromising political style characterized by (1) the motivation to achieve radical transformation of society (2) according to directly felt transcendental imperatives and (3) through political means.[46] Fundamentalism can also refer to those who want to return to early Islamic practices or who strive to adapt, sometimes but not always in a 'radical' manner, the 'fundamentals' of Islam to modern conditions; for example, by reinterpreting traditional Islamic concepts

such as shura (consultation) and ijmaa (community consensus) in the light of modern realities. Fundamentalism is thus not necessarily the same as literalism, and modernism is not necessarily contradictory with a quest for authenticity.[47] A 'fundamentalist' can therefore either be a traditionalist or a modernist, indeed even a liberal. Leonard Binder has observed that 'fundamentalist Islam and liberal Islam draw on the same religious sources, they often employ the same type of reasoning, they usually concentrate on the same authoritative pronouncements, and in some cases the differences between the two may be difficult to discern'.[48]

Historical figures ranging from Ibn Taymiyya (1268–1328) to the Ayatollah Khomeini (1903–89) were at once fundamentalists and modernists. They were creatures of their respective eras who had internalized many of the 'alien' beliefs of their contemporary setting yet fought against alien influences. In their desire to strip Islam of foreign influences and accretions and return to a pristine tradition, they often unwittingly innovated, if only by virtue of transposing ancient ideas, concepts or institutions to a radically different environment. The Ayatollah Khomeini introduced and applied countless innovations to traditional Islamic doctrine.[49] He developed the concept of the rule of the pre-eminent jurist (velayet-e Faqih), and created a republic and a parliamentary democracy (both modern Western concepts) with a Constitution based on an innovative, and sometimes controversial (including in traditional Islamic circles), application of Islamic principles.[50] By the same token, many of today's radical fundamentalists have internalized Rousseau, Fanon or liberation theology and yet invoke authenticity.[51]

The great Islamic modernists of the *Salafiyya* movement could also be characterized as fundamentalists.[52] Edward Mortimer noted that Rashid Rida (1865–1935) undertook the reinterpretation of Islam in the name of fidelity to the distant past (the salaf) and of strict adherence to the basic texts of Islam. He adopted a modernist interpretation of riba but was also an admirer of the militant Wahhabi puritans: 'If "fundamentalism" means an effort to define the fundamentals of one's religion and a refusal to budge from them once defined, then Rida was a fundamentalist indeed. (But surely anybody with serious religious beliefs of any sort must be a fundamentalist in this sense?)' Mortimer concludes: '[T]he precise meaning of [fundamentalism] when used in the context of Islam eludes me'.[53] Similarly, John Esposito has noted that fundamentalism 'tells us everything and yet, at the same time, nothing'.[54] William Shepard summarized best the researcher's dilemma:

> On one hand, such labels have undoubtedly often functioned as obstacles to understanding the actual people and tendencies involved, in part because they are frequently used without explicit definition, in part because they perforce lump together widely differing phenomena, and in part because they often convey an implicit bias or

> value judgment. In my view, this is particularly true of the label 'fundamentalist'. On the one hand, we cannot avoid labels if we are to talk about things, and we certainly cannot begin to make sense of an area as vast and complex as the modern Muslim world unless we can analyze its manifold phenomena into a manageable number of categories with suitable designations.[55]

Another source of confusion is that different groups of scholars have their own codes and conventions. In the French-language scholarship on contemporary Islam, a distinction is drawn between 'Islamists', who have an explicitly political agenda and undertake 'Islamicization from above', and 'neo-fundamentalists', who are associated with 'Islamicization from below' and are primarily concerned with Islamicizing society and promoting religiosity. Within that framework, 'Islamists' and 'neo-fundamentalists' would represent the more recent manifestations of Islam, while 'fundamentalists' would refer to more traditional political movements such as the Muslim Brothers.[56]

In this book, the word 'Islamist' is used generically to encompass groups seeking to upgrade the role of Islam in political and economic life, and the word 'radical' in reference to those, usually anti-Western, groups who seek to attain political power through the use of force. One cannot – despite all the reservations expressed – escape the use of the word 'fundamentalist', if only in the broad sense of 'seeking a return to the fundamentals of Islam'. Whenever the word (and other comparable labels) is used in this book, the precise connotation will be circumscribed by context.

1.4.4 Traditionalism and Modernism

For the purpose of studying modern finance, a useful if imperfect dichotomy is that of 'traditional' vs 'modern' approaches, based respectively on the propensity, when it comes to financial products and concepts, to adopt a literalist, scholastic and legalistic approach, as opposed to the propensity to accept non-Islamic innovations based on an understanding of the 'moral economy' of Islam (see Chapter 3). To put it differently, the key distinction is between those more likely to follow the letter of religious texts (including the fiqh of classical Islam) and those more inclined to reason based on the spirit of the religion.

These are of course 'ideal types' since things are far more complicated in practice. Toward the extremes of the spectrum would be respectively those who have no quarrel with interest rates and therefore see no need for Islamic banking, and those who on principle reject the very concept of banking because it does not go back to early Islam.[57] Most Islamic thinkers, however, fall outside such extremes and could be situated along the continuum. Different shadings and combinations of traditionalism–modernism produce infinite variations. Also, there is no agreement as to

what constitutes 'progress', and the old and the new are likely to co-exist in unexpected ways. As discussions of Iran in this book show, many 'modern' ideas were internalized by 'traditional' clerics. Another illustration of selective adoption of innovations is of course the instrumental use made by the Ayatollah Khomeini of modern technologies during his exile. At the time, audio-tapes of his fiery denunciations of the Shah's regime and of all things Western were duplicated and played throughout Iran.[58] Another even more vivid example of the co-existence of the old and the new would be the use of the Internet to issue wholesale condemnations of modern finance. Thus in a 'cyberfatwa' titled 'The Fallacy of the "Islamic Bank"', Umar Ibrahim Vadillo writes:

> The so-called 'Islamic bank' is a usurious institution contrary to Islam. The 'Islamic bank' is an absurd attempt to resolve, as was done in the case of Christianity, the unswerving opposition of Islam to usury for fourteen centuries. Since its origin, the 'Islamic bank' has been patronized and promoted by usurers.

The author dismisses such a 'usurious institution' as an invention of Western colonialism designed to incorporate the world's Muslims into the international financial and monetary system, adding:

> In contrast to the modernist confusion, the position of the Shariah of Islam is clear and does not admit any controversy. From this it is clear that the Muslim must not only abandon usury but that he is also obliged to fight against usury.[59]

Still, for the purpose of analyzing the role of Islamic finance in the global economy, the traditionalist/modernist distinction is useful. Two strands can be found in the Islamic tradition. One is more 'purist', and worried about foreign influences, the other is more cosmopolitan, more secular and readier to accept the more admirable innovations of non-Muslims. Both strands of course claim authenticity.[60] As various sections of this book show, both have at various times and places been invoked to condone or prohibit certain economic practices. Given the decentralized nature of the religious hierarchy, especially in the Sunni world, virtually any position could be legitimated by some approving fatwa. As usually happens in religious controversies, each side will claim to represent 'true' Islam, and bolster its position through the familiar game of quoting and counter-quoting. For the traditionalists, the words of the Koran and the Hadith, as well as classical fiqh, are sacred, and the interpretive leeway must be limited. Anything new or different is frowned upon. In contrast, modernists, insofar as they believe Islam to be fully compatible with progress, rationality and science, do not feel it necessary to replicate the exact conditions of early Islam, but try to find proper Islamic responses to new challenges.[61] They are likely to draw a distinction between God's law

(as expressed in the Koran) and man-made law (the jurisprudence developed in the early years of Islam).[62] Their ideal is that of the time when Islamic cities were centres of learning and culture, and they praise the flexibility of Islam and the diversity of Islamic economic thought as 'a manifestation of the inherent and natural potential of the divine Word of Allah, i.e., its ability to be interpreted differently and to accommodate varying cultures'.[63]

While the traditional strand may better fit Western stereotypes about Islam, the modern one is probably more common – and likely to achieve further gains in the future – in the areas of banking and finance. Consider for example new, complicated products such as derivatives. The traditional approach would consist in breaking them up into all their components and seeing what the schools of classical fiqh have to say about each of these components. The modern approach, relying on the basic principles and on the moral economy of Islam, would probably be more useful in the global economy.

Or consider zakat (almsgiving). Traditionalists have argued that 'no authority on earth has any right to alter the zakat rates'.[64] They looked upon the fiscal system established at the time of the Prophet and his immediate successors as a perfect and unchangeable system of redistribution that could not be modified. Under that system, rates on certain livestock, fruits and grain are specified with great care. For example, Caliph Umar decreed that dates and grapes were subject to zakat, while peaches and pomegranates were not. A strict application of such rules could have absurd results. And indeed, over time, zakat became an 'ossified, dysfunctional ritual, increasingly divorced from its original purpose'. Contemporary schemes to impose traditional zakat resulted in farmers, many of whom lived below the poverty line, being subjected to the tax, while most property owners and wage earners were exempted.[65] A modernist approach would re-evaluate zakat and recreate it in the light of contemporary institutions and context, rather than simply replicate ancient practices.

1.4.5 Oversimplification and its Consequences

Assessments of Islamic banks tend to fall into one of two categories: excessive claims or outright dismissal. The authorized literature tends to paint an idyllic picture of Islamic finance and economics, a world where 'no inflation, no unemployment, no exploitation and no poverty exist'.[66] In contrast many scholars have been dismissing the Islamic banking phenomenon entirely. Most recent books on Islam have the requisite chapter (or paragraph, or sentence) on Islamic finance, usually containing sweeping and unsubstantiated generalizations about the phenomenon and its significance. One often encounters statements such as this: 'Economic Islam is nothing but "rhetoric" dressing up either a socialist and Third

World statism (Iran under Khomeini), or an economic liberalism oriented more toward speculation than toward production.'[67] On the political implications of Islamic banking, one scholar sees in Islamic finance a potential tool for political transformation,[68] while another sees it as a 'technocratic and non ideological' tool that is designed to adapt the financial sector to the global economy, while 'leaving the social and political order unchanged'.[69] On the issue of how different Islamic banking is from conventional banking, one encounters the same tendency toward sound bites and sweeping pronouncements. Islamic finance is either conventional finance by another name,[70] or a 'financial system fundamentally different from the system currently dominant throughout the world'.[71]

Such claims are not helpful in understanding a complex and multi-faceted phenomenon. The Islamic banking system is by some measures a success, by others a failure. It is in some ways unique, but at the same time, most operations of Islamic banks tend to mirror those of conventional banks. A binary approach cannot capture the nuances of Islamic finance. On the issue of interest, one can be dismissive of all of Islamic finance because 'time has a price measured by interest rates, and no economic system can ignore that'.[72] The argument of Islamic scholars is more subtle. Islamic law in fact accepts the notion of the time value of money or opportunity cost.[73] In the words of Fuad Al-Omar and Mohammed Abdel-Haq: 'The Shariah does … recognize a difference in value due to a time element, and does not prohibit realizing the time-value of money. What is prohibited is any claim to the time-value of money as a predetermined quantity calculable at a predetermined rate'.[74]

Similarly, on the issue of the role of Islam in the global economy and its compatibility with the 'New World Order', a binary approach would be misleading. As this book shows, Islamic finance has thrived in the global economy. Yet while Islam is well-integrated economically, it is often denigrated culturally and politically in the New World Order.[75]

1.5 Capturing the 'Big Picture' of Islamic Finance

This book does not purport to advocate a specific reading of the Shariah in regard to banking and finance. Rather it seeks to show how and why, at various times and places, interpretations and practices have differed. The purpose of this book is to dispel myths and stereotypes, and to present Islamic finance in all its complexity and diversity. Most broad questions on the subject (are Islamic banks successful? are they truly different from conventional banks? what is their political significance? etc.) can only be answered by 'it depends' – surely a disappointing response for those accustomed to sound bites and definitive, if uninformed, opinions on the subject.

As already mentioned, most studies of Islamic finance are characterized by theological, financial and legal reductionism. In addition, most have a strong case-study orientation, focusing on a single country, sometimes on a single bank, to draw broad conclusions. Such approaches give short shrift to the diversity and complexity of the phenomenon. They also prevent capturing the 'big picture' of Islamic finance – putting it in perspective and allowing a better understanding of the significance and likely evolution of the phenomenon. In order to counter the common monolithic, abstract, and dogmatic perspectives, this book will adopt, insofar as it is possible in a single volume, an empirical, historical, comparative and interdisciplinary approach to shed light on a multidimensional topic.

1.5.1 An Emphasis on Context

Writings on Islamic finance tend to have an abstract, idealized character. Few facts are offered, many statistics are fudged or meaningless. A lot is based on the analyses and precepts of the first aggiornamento, with little attention paid to changes in global finance, let alone to the actual practices, results and performances of Islamic banks. Much of the literature posits for example that Islamic banking is all about profit-and-loss sharing, when in reality such operations account for only a tiny part of Islamic banking.

Most studies of Islamic finance assume a closed, monolithic, unchanging world.[76] In contrast this book underscores the diversity of Islamic finance, its dynamic nature and its interaction with its environment. Hence the emphasis on context – historical, political, economic, social and cultural. Examples abound of how deeply embedded Islamic financial institutions are, in their institutional and cultural framework. Saudi Arabia was founded as a 'fundamentalist' Islamic state, in the sense that its society and institutions were based on a strict and 'purist' interpretation of Islam. Paradoxically, this has made the issue of Islamic banking and finance a politically sensitive one. The reason is that by the time Islamic banks came into existence, Saudi Arabia was a wealthy state – to a large extent a rentier economy, living off its oil production and the substantial revenues from its foreign investment and interest income. Its economy was thus heavily dependent, directly and indirectly, on interest. Creating Islamic ('non-interest') banks would make existing banks un-Islamic, in a country where the rulers repeatedly have had to fend off accusations of impiety.

In Egypt, the story of Islamic finance cannot be separated from government policies: in the early seventies the government promoted Islamic banks as a component of infitah ('open-door') policies and as a counterweight to left-wing and Nasserite opposition; in recent years, just as the government's policy against Islamic groups has toughened, the economic – and rhetorical – war between conventional and Islamic institutions has

heated up, each side accusing the other of being un-Islamic. In secular but cash-strapped Turkey, Islamic banks (mostly from oil-rich Gulf states) were welcomed, but were not allowed to use the word Islam in their name, nor refer explicitly to their Islamic character. In Jordan, the policy towards Islamic banks has reflected the accommodative policy towards Islamic groups in general. In Malaysia and Indonesia, Islamic finance has reflected the more syncretic brand of Islam, the developmental nature of government policies as well as a variety of domestic considerations.[77]

In addition to discussing variations of Islamic finance based on different national contexts (Chapter 6), this book will emphasize the evolving context of Islamic finance with reference to the two aggiornamentos. The birth of Islamic finance is a product of the political economy of the 1970s (the increase in oil prices and the new assertiveness of the South, the ascendency of Saudi Arabia in regional politics and its control of the nascent pan-Islamic movement). Since the 1980s, the international political economy has changed beyond recognition. For lack of a better phrase, we will refer to the global economy, the widely used catch-all concept encompassing a wide range of phenomena: the end of the cold war and the emergence of a unipolar world, deregulation and increased openness of markets, the growing role of finance, the acceleration of technological change, etc. A number of sections, particularly in Chapter 5 and in Chapters 8 to 12, will dwell on aspects of the global economy without which the evolution of Islamic finance would not be intelligible.

1.5.2 A Historical Approach

Timur Kuran has written that Islamic economics 'shuns confrontation with historical evidence'.[78] A historical perspective is necessary to dispel the myth of an immutable model. Since its earliest days, economic Islam has known adaptation and change. Indeed, 'the history of Islam's early period contains valuable lessons concerning the need to devise new institutions to cope with new circumstances'.[79] A historical perspective is also necessary to understand the changing nature of the relations between Islam and the West, and the consequences of the alternation of eras of growth and ascendency with periods of stagnation and decline. At a time when Europe was still in the Dark Ages, culture and knowledge thrived in the Islamic world. Later, as the West went through its 'great transformation',[80] the Islamic world remained stagnant. By the nineteenth century, most of the Islamic world was brought into a Western-imposed economic order for which it was ill-prepared. Between the golden age of Islam and this encounter, the world of ideas and institutions had changed dramatically. Most institutions with relevance to finance that exist today – capital markets, corporations, etc. – did not exist in the early days of Islam. Equally important though less visible were changes in mindsets – new under-

standings of cause and effect on matters of wealth creation; new empirical and normative perspectives on debt, risk, wealth, etc.

The modern 'market system' revolutionized political, economic, social and human relations. An intellectual and institutional revolution preceded and accompanied these changes.[81] The 'modern' society was characterized by a different ethos, and different institutions and belief systems. The 'science' of political economy, later 'economics', based on the interaction of self-interested individuals in a world of scarcity, dealt a blow to the communal bases of pre-modern or proto-economies. Although financial transactions had existed for a long time, there were, until the fourteenth century, no institutions exclusively devoted to banking. The birth of modern banking occurred in northern Italy and soon spread to all of Europe.[82] One intellectual development is especially worthy of mention in connection with modern financial instruments: new attitudes toward risk made possible by new discoveries in mathematics and probabilities in due course revolutionized finance.[83]

Along with economic and political transformations came new perspectives on debt and indebtedness. The long-held view could be summarized by the famous lines from Hamlet:

> Neither a borrower, nor a lender be;
> For loan oft loses both itself and friend,
> And borrowing dulls the edge of husbandry.
> (I, iii, 75–7)

Then, following the rise of capitalism and the industrial revolution, credit acquired a positive connotation. Walter Bagehot wrote in the nineteenth century: 'In countries where there is little money to lend, and where that little is lent tardily and reluctantly, enterprising traders are long kept back, because they cannot at once borrow the capital, without which skill and knowledge are useless'.[84]

In the Islamic world, ideas and perceptions have also changed, though not necessarily in the same way. The law has evolved,[85] as did rhetorical arguments on most issues.[86] In the effort to interpret Islam in the light of changing circumstances, or to reconstruct old paradigms, it is essential to relate ideas to their specific context. From that standpoint, Islam may not be as irreconcilable with modern finance as many think.

Indeed, in some respects, classical Islam anticipates modern finance. Islam innovated in its perspective on private property, its emphasis on written contracts, and more generally, its favourable view of business endeavours. Some Islamic business forms, such as the commenda partnership, have found their way in European legal codes. And when medieval Europe tried to circumvent its own restrictions on interest, it adopted certain Islamic hiyal.[87] Many of the advances in knowledge had an impact on future discoveries. In particular, the role played by the Arab numbering

system and other mathematical discoveries marked the crucial link between ancient Indian knowledge and discoveries of the modern age.[88] Many contributions proved critical to later advances in probabilities, statistics, and eventually risk analysis and modern financial tools. Omar Khayyam (1050–1130), best known as a poet and philosopher, was also a mathematician whose findings 'formed the basis of concepts developed by the seventeenth-century French mathematician Blaise Pascal, one of the fathers of the theory of choice, chance and probability'.[89] It should therefore not be surprising that the word hazard comes from the Arabic *al-zahr* (meaning dice), that the word algebra comes from *al-jabr* (meaning the assemblage of broken parts), or that the word algorithm (rules for computing) comes from Al-Khawarizmi, a ninth-century mathematician.

Yet if the Islamic world seemed throughout its golden age to be on the cusp of great discoveries, the period between the fifteenth and the twentieth centuries was one of stagnation and decline. Mohammed Arkoun noted that, during that period, much of the Islamic world experienced a double break – with its own past (the classical era of the seventh through the fourteenth century), and with the West. In the field of knowledge, 'a huge area was not thought about, and was thus unthinkable'.[90] In Bernard Lewis's formulation, 'The Renaissance, the Reformation, even the scientific revolution and the Enlightenment passed unnoticed in the Muslim world.'[91] Hence the discontinuity between the fifteenth and the twentieth centuries, and the need for Muslim revivalists to reconstruct or reinvent the Islamic past. In the words of Muhammed Arkoun, a 'tinkered coherence was found based on arbitrarily selected fragments and traditions'.[92]

In terms of available financial instruments, the Islamic world was, at least until the thirteenth century, far more advanced than the West. Although banks did not exist (as noted by Abraham Udovitch, it was a world of 'bankers without banks'), innovative financial instruments, many of which anticipate later conventional ones, were a part of commercial life. (Some have argued that the word check [cheque] derives from the Arabic *shakk* [written non-monetary document].)[93]

In Udovitch's interpretation, the reasons why banks did not develop in the Islamic world had to do with the structure of economic life. For one thing, finance was never an autonomous activity; it was always a subset of commerce. And to a much greater extent than in the European economies of the late Middle Ages, financial relationships were embedded in personal and communal ties. Western banking arose as a combination of two factors: the generation of capital by means of deposits of the many on the one hand, and money lending and the provision of credit for the few on the other. In the Islamic world, there was a disconnection between deposit and credit, and financial intermediation (the conversion of deposits into loans) was therefore not necessary. Indeed, money in the Islamic world was deposited for safekeeping (al-wadia), whereas in Europe deposits could be

used by the safekeepers.[94] In one case it was to be returned untouched while in the other it could be used for credit purposes. In the Islamic world, credit and financing operations were conducted through transactions, usually involving profit-and-loss sharing, unrelated to safekeeping.

In addition, the need to aggregate small deposits and lend them was driven by the needs of perennially impecunious European princes. In Islam, advances of cash to the public treasury and ruling dynasties took the form of tax farming arrangements 'in which individuals possessing liquid capital – presumably generated from commercial profits – advanced cash to the government in return for the right to farm the taxes of a given region for a given period'.[95]

Such historical considerations are crucial to understand the evolution of Islam, and to extract the spirit or the moral economy of the religion, yet they are virtually non-existent in the writings on Islamic finance.

1.5.3 A Comparative Approach

In addition to historical references, there will be frequent comparative references (mainly in Chapters 3 and 12). Comparisons are of course necessary to put any phenomenon in its proper perspective, and draw useful parallels. In the case of Islam, and of Islamic finance, they are all the more necessary so that common myths evoked earlier can be dispelled.

On the 'uniqueness' of Islam as a 'comprehensive way' of life, John Esposito writes:

> What most forget is that all the world's religions in their origins and histories were fairly comprehensive ways of living. While the relationship of religion to politics has varied, religion is a way of life with a strong emphasis on community as well as personal life: the way of the Torah, the straight path of Islam, the middle path of the Buddha, the righteous way (dharma) of Hinduism. They provide guidance for hygiene, diet, the managing of wealth, stages of life (birth, marriage, death), and ritual and worship.[96]

On matters of economics and finance, the Bible has over 2,000 references to debt, saving, and charitable giving.[97] The Talmud provides detailed injunctions on all aspects of business behaviour. The Canon law of the Church discussed usury in excruciating detail. Nor are secular financial institutions necessarily divorced from religious considerations. In late nineteenth-century Germany, Frederic Raiffesen, a Protestant, and in early twentieth-century Canada, Alphonse Desjardins, a Catholic, created mutual savings societies out of a moral/religious impulse (neither of them was a banker) to save poor farmers from the clutches of money-lenders.[98] Today, a substantial amount of social investing is done by religious groups[99] and on most issues of finance, ethical concerns (which are themselves

heavily coloured by religion) are ever-present. By the same token, the religious revivalism movement is not exclusive to Islam, though it is seldom discussed from a comparative perspective.[100]

1.5.4 An Interdisciplinary Approach

In order to capture the many facets of Islamic finance, an interdisciplinary approach is necessary. Most of the issues evoked can be looked at from different angles. Looked at from a purely economic angle, the riba debate may not seem like a big deal given that something equivalent to interest is likely to be devised, albeit under a different name. Yet this very issue is quite consequential if considered from a marketing or from a religious standpoint. The economist may conclude that 'there is no such thing as Islamic finance' while for a banking executive – considering that 'product differentiation' is essential to strategy – devising and selling an 'Islamic product' will be significantly different from devising and selling a 'conventional product'. Similarly, from a religious standpoint – that of a devout customer or that of religious authorities – differences that are invisible to the secular eye could be far from inconsequential. Five dimensions of the Islamic banking phenomenon are singled out for discussion in the last chapters of the book: management, economics, regulation, politics and religion.

Notes

1. For more specific definitions, see Chapter 3.
2. For example, prayer rooms, business hours that do not conflict with prayer and other religious obligations.
3. A complicating factor in classification is that a distinction must be drawn between 'Islamic financial institutions' whose entire product line is Islamic, and 'Islamic products', increasingly offered by conventional institutions in addition to their conventional products.
4. Author's database.
5. *The Economist*, 5 March 1995.
6. Hamid Algabid, *Les banques islamiques*, Paris: Economica 1990, p. 217.
7. The AAOIFI has established standards that were officially effective at the end of 1995. Many Islamic institutions however still follow their own procedures.
8. Algabid, pp. 110–111.
9. Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law*, London: Graham and Trotman 1995, pp. 90–1.
10. Ray, p. 150.
11. Elias Kazarian, *Islamic Versus Traditional Banking: Financial Innovation in Egypt*, Boulder: Westview Press 1993, p. 227.
12. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*, Paris: Presses Universitaires de France 1997.
13. MESA Bulletin 29 Middle Eastern Studies Association, July 1995.
14. Ray, p. 3.

15. Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk and Return*, The Hague: Kluwer Law International 1998, p. 45.
16. Ray, p. 3.
17. Karen Pfeifer, 'Is there an Islamic Economics?' in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, pp. 161–2.
18. Alan Richards and John Waterbury, *A Political Economy of the Middle East*, Boulder: Westview Press 1996, p. 351.
19. See for example Hugh Roberts, 'Doctrinaire Economics and Political Opportunism in the Strategy of Algerian Islamism', in John Ruedy (ed.), *Islamism and Secularism in North Africa*, New York: St Martin's Press, p. 60.
20. *US News and World Report*, 20 July 1998.
21. Francis Fukuyama, *The End of History and the Last Man*, New York: Avon Books 1993, pp. 46 and 217.
22. Samuel P. Huntington, *The Clash of Civilizations and the Remaking of World Order*, New York: Simon and Schuster 1996, pp. 70 and 72.
23. Compare for example with Leonard Binder, *Islamic Liberalism: A Critique of Development Ideologies*, The University of Chicago Press 1988, and Olivier Carré, *L'Islam laïque ou le retour à la Grande Tradition*, Paris: Armand Colin 1993.
24. Judith Miller, *God Has Ninety-Nine Names: A Reporter's Journey Through a Militant Middle East*, New York: Simon and Schuster 1996, p. 151.
25. Roland Jacquard, *Fatwa contre l'Occident*, Paris: Albin Michel 1998, pp. 157–68.
26. Ibrahim Warde, 'Perceptions of Islamic banks among European and American bankers', San Francisco: IBPC Working Papers 1997.
27. Ibid.
28. John L. Esposito, *The Islamic Threat: Myth or Reality?*, Oxford University Press 1992, p. 205.
29. Aziz Al-Azmeh, *Islam and Modernities*, London: Verso 1993, p. 140.
30. Sami Zubaida, 'Is Iran an Islamic State?', in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 103.
31. See Chapters 2 and 12.
32. Timur Kuran, 'The Economic System in Contemporary Islamic Thought: Interpretation and Assessment', *International Journal of Middle East Studies* 18 (1986), p. 140.
33. William E. Shepard, 'Muhammad Sa'id Al-Ashmawi and the Application of the Shari'a in Egypt', *International Journal of Middle East Studies* 28 (1996).
34. Esposito, p. 202. See also Yahya Sadowski, '"Just" a Religion: For the Tablighi Jama'at, Islam is not totalitarian', *Brookings Review* Summer 1996, Vol. 14 No. 3.
35. Bernard Botiveau and Jocelyne Cesari, *Géopolitique des islams*, Paris: Economica 1997, pp. 40–1.
36. Yvonne Yazbeck Haddad (ed.), *The Muslims of America*, Oxford University Press 1993.
37. Rémy Leveau, 'Maghrebi Immigration to Europe: Double Insertion of Double Exclusion?', in Charles E. Butterworth and I. William Zartman, *Political Islam, The Annals of the American Academy of Political and Social Science*, November 1992, pp. 170–80.
38. Botiveau and Cesari, pp. 84–90.
39. Carré, p. 58.
40. See Chapter 12.
41. Al-Azmeh, 1993, p. 1.
42. William E. Shepard, 'Islam and Ideology: Towards a Typology', *International Journal of Middle East Studies* 19 (1987), pp. 307–36.
43. Esposito, p. 77.

44. R. Hrair Dekmejian, *Islam in Revolution*, Syracuse University Press, 1995, p. 57.
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47. Joel Beinin and Joe Stork, 'On the Modernity, Historical Specificity, and International Context of Political Islam', in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 3.
48. Binder, p. 357.
49. Chibli Mallat, *The renewal of Islamic law: Muhammad Baqer as-Sadr, Najaf and the Shi'i International*, Cambridge University Press 1993.
50. Sami Zubeida, *Islam, The People and the State: Essays on Political Ideas and Movements in the Middle East*, London: Routledge 1989, p. ix.
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54. Esposito, p. 7.
55. Shepard, p. 307.
56. See for example Olivier Carré, *L'Islam laïque ou le retour à la Grande Tradition*, Paris: Armand Colin 1993; Gilles Kepel, *La revanche de Diew: Chrétiens, juifs et musulmans à la reconquête du monde*, Paris: Editions du Seuil 1991; or Olivier Roy, *L'échec de l'Islam politique*, Paris: Editions du Seuil 1992.
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73. Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk and Return*, The Hague: Kluwer Law International 1998, p. 2.
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96. Esposito, p. 198.
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99. See Chapter 7.
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2

ISLAM, ECONOMICS AND FINANCE

Any successful belief system, whether religious or secular, has seemingly contradictory characteristics: it is malleable enough to adapt to a variety of geographical settings and survive the test of time, yet it must be able to maintain its specificity, or else it would disappear or become fused with competing belief systems; it is idealistic, sometimes even utopian, yet capable of adjusting to human imperfection and making the kinds of compromises that are endemic to political and economic life. With this in mind we can better understand how a system rooted in the Middle Ages could survive, and thrive, in the global economy.

Following a broad overview of the parallel evolution of religion and history, this chapter explores the mechanisms by which Islam adapted to changing circumstances, and explains how Islam could accommodate itself with modern economics and finance.

2.1 Historical and Religious Background

The tenets of the Islamic religion can be conceived as a pyramid. At the top stands the Koran, considered by Muslims to be God's word as conveyed to the Prophet Mohammed. Below it are the Hadith and the Sunna. Often used interchangeably, the first actually refers to the words and deeds of the Prophet while the second refers to the tradition or path established by those words and deeds. In other words, the Hadith, in the form of a large and ill-defined number of short texts, relates stories about and sayings (specific pronouncements, deeds, or approvals of other people's actions) of the Prophet, whereas the Sunna consists of the practices and rulings deduced from such narratives.

As for issues and questions not addressed by those primary sources, the proper Islamic view can be obtained through ijmaa and qiyas. Ijmaa means consensus, and is based on the notion that the communal mind of Muslim scholars of a particular age provides assurance of freedom from error. Qiyas refers to reasoning by analogy or by logical inference based on primary sources. Jurists, through devout and careful reflection and effort (ijtihad) can derive appropriate rulings, by figuring out how the Prophet

and his four immediate successors – the 'right-guided caliphs' – would have acted, or what the accumulated wisdom of the community would prescribe. The Shariah is the Divine Law derived from all these sources. Though usually translated as Islamic Law, the Shariah is in the eyes of certain scholars a broader term not designating law per se, but 'designating good order, much like nomos'.[1]

Indeed, in various matters including economic ones, there are sharp disagreements as to what the Shariah dictates. The further down the pyramid, the broader the possible interpretations. The Koran, a short, specific text, is considered divine and eternal since it is the revealed word of God. The Hadith – a collection of narratives which were not set down in writing until two or three centuries later – provides a first area of controversy. A great number of Hadiths were deemed apocryphal, typically fabricated to support a particular political faction or opinion, and a long process of authentication did not dispel all doubts about the veracity of certain texts. Interpretations can still differ quite significantly. Also, different traditions authenticate different Hadiths. In addition, Islamist groups over the ages have disagreed on the relative importance of the various tenets of the religion, some, for example, having called for reliance only on the Koran, and for a disregard of the 'man-made' elements of religion that developed over time.[2]

Such disagreements explain why different schools of jurisprudence (fiqh) developed over the years, each contributing different interpretations of the Shariah. By the tenth century, four main schools had emerged within the orthodox Sunni tradition (the Shia had their own, separate schools): Hanafi, Shafii, Maliki and Hanbali. Every Sunni is in theory a follower of one of these schools. In classical Muslim society, four qadis (judges) in each major city would apply one of these four traditions to fill in areas of the law that were left undiscussed in the Koran and Sunna. Over the years, however, each school found particular favour in certain localities, hence the geographical concentration of adherents that can be found nowadays. Hanbalis are primarily concentrated in Saudi Arabia. Malikis predominate in North and West Africa. Shafiis are a majority in Indonesia, Malaysia, East Africa, Yemen, and parts of Egypt. The most widespread of the schools is the Hanafi, which was once the official school of the Ottoman empire, and is thus influential in Turkey as well as Egypt, Syria, Lebanon, Jordan and Iraq. It is also adhered to in much of the Indian subcontinent.

The legal methodologies of these schools differ, combining different proportions of textual authority and analogical reasoning: the Hanbalis tend to adhere to literal interpretations of religious texts, while the Malikis and Hanafis allow wider discretion in the interpretations of such texts. On a specific issue, different schools may be clear, ambiguous or silent. They also may be lenient or strict. In addition, individual countries differ in their eclecticism: in Algeria or Morocco, for example, only Maliki interpreta-

tions of the Shariah are allowed in court, while in Egypt interpretations based on any of the four schools are admissible.[3]

A combination of external influences and idiosyncratic evolution has led to significant diversity throughout the Islamic world, which in turn translated into growing doctrinal differences. All this of course runs counter to common generalizations. Thus, though the language of Islam emphasizes a unified 'umma' (Islamic nation), the reality is far more complicated. A truly unified and coherent community only existed in the early years of Islam. In 657, the first schism occurred, involving the Kharijites ('the goers-out'). An even more significant split occurred in 661 when followers of Ali refused to acknowledge the authority of Muawiyah (the founder of the Umeyyad dynasty) and his successors, thus creating the Shia–Sunni divide. By the tenth century, with the appearance of rival caliphates in Egypt and in Spain, the notion of a unified 'umma' became even more of a fiction.[4] In later centuries, such fragmentation increased significantly.

It is thus a mistake, common perceptions notwithstanding, to see Islam as a monolith. It follows that most facile generalizations deserve to be nuanced. For example the extent to which Islam fuses church and state ('din wa dawla') depends upon the period or the region under consideration. Under the Prophet Mohammed (622–32) as well as the first four ('rashidun' or 'rightly-guided') caliphs (632–61) – Abu Bakr, Umar, Uthman and Ali – temporal and spiritual power were inextricably linked. This period, which also coincided with remarkable territorial expansion, embodies the ideal of Islamic rule and social organization, a model that successive generations have striven to emulate.

But soon afterwards, with the advent of the Umeyyad dynasty (661–750), some measure of separation of temporal and spiritual functions appeared. According to historian Philip Hitti, Muawiyah, by introducing 'innovations' opposed by religious conservatives, by surrounding himself with non-Muslims, and by creating a hereditary dynasty, 'secularized Islam and transformed the theocratic caliphate into a temporal sovereignty'.[5] Nor is the impact of foreign influences on Islamic doctrines and practices sufficiently understood. Again, in the Umeyyad era, as explained by Albert Hourani, 'The ruler, his governors and special deputies, the qadis, dispensed justice and decided disputes, taking into account the existing customs and laws of the various regions'.[6] Further expansion and absorption of foreign influences occurred in the Abbassid era (750–1258). Although it was accompanied by bureaucratization, centralization, and attempts to reassert religious legitimacy, the cosmopolitan nature of the Abbassid empire further diluted the original Arab influence. In sum:

> Just as the Shariah had grown up by a slow and complicated process of interaction between the norms contained in the Koran and Hadith and the local customs and laws of the communities brought under the rule of Islam, so there was a continuing process of mutual

> adjustment between the Shariah, once it took its definitive form, and the practices of Muslim societies.[7]

The 'definitive form' occurred in theory with the 'closing of the gates of ijtihad'. Yet when and why the gates were closed – and most importantly whether those gates were really ever closed – is still being debated.[8] One common explanation for the insistence that the Shariah had taken its final form is that with the increased dilution of the original Arab–Islamic norms which occurred with the gradual weakening of the Abbassid empire, and culminating with the Mongols' invasion of Baghdad in 1258, Muslim jurisprudents, fearing that alien customs and norms would subvert the Islamic legal system, arrived at a consensus: from then on, no new laws would be produced.[9] With the formal collapse of the Abbassid empire, the centres of power moved further away from the Arab core towards the Turkic world, and the Islamic world grew ever more fragmented.

Though the rhetoric of the unity of spiritual and temporal power remained, secularist trends have been on the rise since the tenth century. In the words of Edward Mortimer:

> In a sense … all genuine political authority in the mainstream Muslim tradition was secular after the loss of effective power by the Abbassids in the tenth century AD. Virtue and justice were no longer regarded as indispensable qualifications of a ruler. Full enforcement of the Shari'a came to be seen as an ideal rather than a necessity. Political power was no longer the instrument through which the ideal community could be realized, but merely a prosaic necessity for the maintenance of order and security, and thus of the minimum conditions in which the faith could be practised and the Muslim community survive.[10]

Similarly, Olivier Carré has argued that after the tenth century, the 'great tradition' and the 'real orthodoxy' of Islam separated politics and religion. Divine law was limited to improving a government's policies by prescribing certain social correctives.[11]

Throughout its golden age (roughly the seventh to tenth centuries in the Middle East, and the eleventh to fourteenth centuries in North Africa and Spain), the Islamic world did not fit the image of a narrow-minded theocracy. Great libraries and translation centres were established where the great works of philosophy, literature, medicine and science from East and West were collected and translated. Such knowledge was improved upon and formed a necessary link to later advances in the West. Bernard Lewis noted that in that golden age Europe looked from the Islamic world 'as central Africa looked to Victorian England'.[12]

So where does the persistent image of an Islam incapable of separating mosque and state – indeed incapable of dealing with modernity and change – come from? The answer lies in the parallel evolutions (and

occasional clashes) of Islam and the West, starting with the end of the Islamic golden age. In the later Middle Ages, while Islamic culture and civilization still thrived elsewhere (in North Africa and Spain, for example), the birthplaces of Islam and of the early Islamic empires had entered a long period of stagnation. In later centuries, with a few exceptions, the Islamic world continued to stagnate, while European powers forged ahead. A well-known chain of historical events – the Renaissance, the Reformation, the Enlightenment, the Industrial Revolution, Imperialism – created an unprecedented economic, political, cultural and intellectual gap between the Islamic world and the West. Characteristically, the Ottoman empire, the last great Islamic empire, once feared by the Christian West, was considered, for at least its last 200 years, 'the sick man of Europe', an ever-weakening entity susceptible to all forms of encroachments by foreign powers.

Of particular interest to us are the political, economic and cultural impacts of the Western ascendency on the Islamic world throughout the colonial – or 'modern' – era, generally dated from Napoleon's 1798 Egyptian campaign. Until then, most of the Islamic world had lived in relative isolation and kept to its traditional ways. While certain Islamic societies had proven quite dynamic, others had remained stagnant for generations. In those communities, there was a deep-seated suspicion of innovation (bidaa). Yet in a changing world, the habit of condemning absolutely every practice that did not go back to the time of the Prophet could not be sustained. Innovations would be analyzed on the basis of their intrinsic merits. In the confrontation with a strong and assertive Europe bent on exporting its ideas and institutions, certain scholars were more inclined than others to adopt alien ideas and customs. Hence the disagreements between those who favoured taqlid (imitation) and those who advocated islah (reform) or tajdid (renewal).[13]

By the late nineteenth century, most countries followed a path of Westernization and secularization that led them to adopt, under foreign tutelage, Western models in politics, economics, law, and education. Muslims were divided. While some did not see a necessary contradiction between Islam and Westernization, a number of political and religious movements emerged throughout the Islamic world, calling for a return to Islamic values and traditions. There was no clear consensus, insofar as some wanted a return to the past while others called for an update of Islamic doctrine. Islamic modernists shared with traditionalist Islamist groups the belief that the ills of society were caused by the betrayal of Islamic ideals. While they shared with secularists the embrace of reason, science and progress, what set Islamic modernists apart was their belief that political liberalization and intellectual reawakening could be, indeed had to be, rooted in a return to Islam. The Wahhabis of Saudi Arabia, the Mahdists of the Sudan, the Sanussis of Libya and other 'fundamentalist'

movements that emerged in the eighteenth and nineteenth centuries, drew their rhetoric and their ideals from the early Islamic Age. The 'new' ideology, seeking to blur the lines between religion and politics, has been characterized by Olivier Carré as a 'deviant orthodoxy'.[14]

Another characteristic of many such fundamentalist movements was their anti-Western character, which worked in perfect symbiosis with the anti-Islamic bias of certain Westerners, justifying and reinforcing stereotypes. A whole tradition of Orientalist writers posited axioms that later came to shape common perceptions of Islam.[15] Writer Ernest Renan proclaimed the Muslim to be 'incapable of learning anything or of opening himself to a new idea'.[16] And Lord Cromer, who ruled Egypt in the late nineteenth century, argued that 'Islam's gradual decay cannot be arrested by any modern palliatives however skillfully they are applied'.[17]

Among social scientists, there is a venerable tradition, going back at least to Max Weber, that looks at Islam as a closed system whose essence is inhospitable to development and modernity. Yahya Sadowski observed:

> When the consensus of social scientists held that democracy and development depended upon the actions of strong, assertive social groups, Orientalists held that such associations were absent in Islam. When the consensus evolved and social scientists thought a quiescent, undemanding society was essential to progress, the neo-Orientalists portrayed Islam as beaming with pushy, anarchic solidarities. Middle Eastern Muslims, it seems, were doomed to be eternally out of step with intellectual fashion.[18]

There were, nonetheless, from the nineteenth century, significant attempts to modernize Islamic doctrine. Perhaps the most influential movement was the Salafiyya, founded in Egypt in 1883 by the pan-Islamic forerunner Jamal al-Din Al-Afghani (1839–97), a Persian whose influence was felt throughout the Islamic world. Through their journal *al-Manar*, Al-Afghani and his disciples, the Egyptian Muhammad Abduh (1849–1905) and the Syrian Rashid Rida (1865–1935), sought to bring about political, legal, and intellectual reform.[19] The movement encapsulated the complexity of the phenomenon. Edward Mortimer saw in Al-Afghani 'an example of three types of Muslim response to the West: the defensive call to arms, the eager attempt to learn the secret of Western strength, and the internalization of Western secular modes of thought'.[20] In sum, modernity – undertaking a radical reinterpretation of Islam to suit modern conditions – is not easy to dissociate from a quest for authenticity. And fundamentalism – if defined as the effort to return to the fundamentals of the religion – is not necessarily the same as literalism.

2.2 Islamic Economics

Commerce is central to the Islamic tradition. The Prophet Mohammed was himself a merchant. Born in the Banu (sons of) Hashim clan of the Quraysh tribe, Mecca's leading traders, he was orphaned in childhood and raised by his uncle, Abu Talib, who taught him the caravan trade. In his twenties, he became the commercial agent of a rich widow whom he later married. It should therefore come as no surprise that in the early Islamic literature, merchants were glorified, or that commercial profit is sometimes referred to as 'God's bounty'. Whereas it took Christianity centuries before it stopped regarding business as a degrading occupation,[21] Islam from its inception explicitly legitimized private property, business enterprise and profit. As long as the merchant fulfils his religious duties, he is rewarded spiritually as well as materially (2:198, 73:20).[22] Unlike the Jewish and the Christian Sabbaths, Friday is not a full day of rest: before and after the religious gathering, Muslims are expected to carry on their worldly activities (62:9–10).[23] Another illustration of the close connection between commerce and religion is that the Islamic religion was spread in many parts of the world (such as Africa and the Far East) by proselytizing merchants

In Mohammed's day, the economic system was quite simple. Mecca, at that time Western Arabia's wealthiest city, depended heavily on trade, but from a regional perspective it was somewhat backward and inconsequential. The continuous spread of Islam soon brought the region's lucrative trade routes, previously controlled by Byzantium and Sassanid Persia, under Islamic control. Muawiyah and his Umeyyad successors expanded the empire from their new capital, Damascus, into Europe and to the borders of India and China, inaugurating a new era of prosperity. The Abbassid caliphate, based in Baghdad, established links between the Mediterranean basin and the Indian Ocean, creating a single trading system that brought about significant changes in agriculture and crafts, and the emergence of great cities.[24]

As the economy became increasingly complex, a number of previously unknown questions – about administering an empire, regulating trade, taxation, etc. – had to be addressed. Institutional innovation occurred, for example with the creation of hisbah, an office in charge of supervising markets, providing municipal services, and settling petty disputes.[25]

The Islamic literature on such subjects as contract law grew to account for every possible eventuality. As for more theoretical issues dealing with economics, they were largely ignored by the fuqaha of the classical age.[26] There were however a few thinkers who dealt with economic issues, the most famous of whom is Ibn Khaldun (1332–1406). Best known for his pioneering work in history and sociology, he also wrote about supply and demand, capital formation, trade cycles, and the theory of value. Still, Ibn Khaldun, usually considered to be the greatest economist of Islam, was

writing in the period immediately preceding the great transformation of the world economy, on the eve of the era of major discoveries, which was to be followed by the rise of capitalism and the industrial revolution. More importantly for our purpose, banks and other modern-style financial institutions had not yet come into existence. When they did, Islamic scholars had to struggle to reconcile a scholarly and legal tradition rooted in the medieval age with the exigencies of the modern world.

Modernists managed to extend their influence with various degrees of success throughout the Islamic world. Most constitutions and legal codes that were written in subsequent decades would usually invoke the Shariah, although in practice references to Islam were limited (typically stating that the state religion would be Islam, that the head of state would be a Muslim, and that the Shariah would be a source of law). Most areas of the law (with certain exceptions, such as family law) were inspired directly or indirectly by Western models. For example, Egypt under Mohammed Ali was directly inspired by France's Napoleonic code. (By later using Egypt as a model, other Islamic countries were indirectly influenced by French ideas.) In addition, with the importation of Western models, the role of the ulema was reduced, and that of elected representatives enhanced. Thus even where the Shariah may have been 'the principal source of all legislation', elected representatives had wide discretion to use other sources of legislation as well.[27]

As the colonial era came to an end, newly independent states came to reassess their economic policies. The 1950s and 1960s saw the advent of economic nationalism, with its emphasis on the role of the state as an engine of growth and development.[28] Neither this statism nor the later liberalization would be significantly challenged on strictly religious grounds. Indeed, in economics as in politics, Islam does not provide an explicit blueprint. Two strands of Islam could be used to justify one or the other set of policies. Liberals played up Islam's accent on property rights and the glorification of commercial profit to advocate laissez-faire. Socialists emphasized the Koran's focus on justice (adl) and compassion towards the needy to justify state intervention as well as redistributive policies.[29]

But although the process of economic decision-making was significantly secularized, references to Islam were seldom absent. Thus Nasserite Egypt had founded the Islamic Congress (in conjunction with Saudi Arabia and Pakistan)[30] and created the Supreme Council of Islamic Affairs which published *Minbar al-Islam* (The Pulpit of Islam). And in pursuing controversial policies on matters such as nationalization, land reform or family planning, Islamic symbols and references were occasionally used, and the government was careful to obtain approving fatwas.[31]

But since Ibn Khaldun the Islamic world had not really produced any prominent economist.[32] The ideological debates of the modern era had been framed according to Western norms. In the liberal era, Muslims who

had studied Western-style economics (and related fields) tried to transpose that knowledge to the Islamic world. With decolonization and the nascent trend towards a return to Islam, religious scholars attempted to rethink economics and the social sciences in the light of their religious training, with the goal of creating an 'authentic' or at least indigenous brand of economics.[33] Rather than simply asserting claims based on divine revelations, and which human beings cannot refute, Islamic economists have gone to great lengths since the 1970s to buttress their case with logic, scientific theory and empirical evidence.[34] Rodney Wilson observed that '[t]here has been more written on Islamic economics in the last two decades than in the previous fourteen hundred years'.[35] Yet in the words of Chibli Mallat:

> Many of the works tend to dabble in generalities and to err in a lack of rigour which prevents the emergence of a serious and systematic literature. The recent 'fad' of 'Islamic economics' has impressed the production with an urgency that has kept the literature produced so far to a superficial and repetitive standard.[36]

It is usually agreed that the most original work is that of Mohammed Baqer as-Sadr, whose book *Iktissaduna* ('our economy') is a far-reaching critique of both capitalism and Marxism, and an attempt to develop an Islamic approach to economics.

For Baqer as-Sadr, 'Islamic economics is not a science (ilm)', but simply a doctrine (madhab). In other words, it is not designed to explain why economic events occur, but to shows the path to follow. It is principally based on the idea of justice, which is by essence a matter of 'ethical appreciation'. It is subordinated to a totality ultimately determined by religion. The three basic principles of the Islamic system are 'multifold property', 'limited economic freedom', and 'social justice'. As for dealing with scarcity and wealth creation, Baqer as-Sadr focuses on distribution, 'before and after production'. A distribution system must be established based on the moral principle of 'general insurance and social solidarity' and taking into account labour, need, and Islam's original view of property.[37] While it could be easily criticized, the work of Baqer as-Sadr was original enough to warrant serious attention. And although critical of capitalist and socialist ideologies, it incorporated elements of both, showing that Islam was not incompatible with modern economics.

With the newfound wealth of oil-producing countries and the rise of Islamic militancy, the need to promote further thinking on economic matters gained new urgency. The proliferation of research institutes, and the encouragement of an 'ijtihad' designed to update Islamic beliefs, resulted in countless attempts to define a system that would be at once internally consistent, faithful to Islamic principles, and adapted to the contemporary world. A number of fiqh academies sprouted throughout

the Islamic world, with the purpose of providing such authoritative opinions. Unable to speak in a single voice, modern Islamists have settled for majority-based decisions. Thus, in a new twist to the old doctrine of ijmaa (consensus), scholars have been engaging in group or collective ijtihad. Gathering in convocations, scholars deliberate collectively and decide questions by a majority vote.

In 1976, the First Islamic Conference on Islamic Economics was held in Mecca. For the first time in Islamic history, a high-level conference dealt exclusively with economic matters. Concrete steps were taken to survey the field and promote Islamic economics as an academic discipline. King Abdul Aziz University established the International Center for Research in Islamic Economics (ICRIE) in 1979 to conduct and support theoretical and applied research in various sub-fields.[38] Such research institutes proliferated throughout the eighties and nineties, and more universities expanded their teaching of Islamic economics.[39] Starting with Pakistan in 1977, a growing number of countries sought to Islamicize their economic systems. Islam would typically be presented as offering a 'third way' between capitalism and socialism that would be not only different, but also superior to, and no less efficient than, the two others. In a few instances – as in Libya in the 1970s and 1980s where Moammar Qaddafi's 'Green Book' presented an idiosyncratic brand of radical socialism – the system proposed was closer to the socialist end of the continuum.[40] But as later sections will show, since the late 1980s, the 'third way' reflected the global neo-liberal trend, and was in most Islamic countries far closer to the capitalist end of the continuum.

2.3 Adapting to Changing Circumstances

As already mentioned, no belief system that has flourished over a long period of time and in a variety of places could have done so without some measure of adaptability. Even a scholar with the unimpeachable Islamic credentials of Mohammed Baqer as-Sadr noted that the texts of the Koran and the Sunna 'do not manifest – generally – their legal or conceptual content in a clear precise manner'.[41] In drawing up the economic rules, more effort – more ijtihad – is needed. And if we consider the institutions created by the Iranian revolution – the most significant Islamic revolution in modern times – a substantial amount of innovation has taken place.

It should be noted at first that Islamic commandments are not as unbending as they would superficially appear. Traditional Islamic injunctions are not framed as simple dichotomies, but situated along a continuum, thus allowing significant flexibility. In the early Islamic community, an action (either for the community as a whole, or for every single member of it) could be regarded as obligatory (wajib), meritorious (mustahabb), morally neutral (mubah), reprehensible (makruh), or forbidden

(haram). Also, most injunctions contain dispensations and exceptions, thus showing considerable flexibility and pragmatism. On the subject of fasting during Ramadan, the sick and the travellers could postpone their fasting, and those for whom it would cause hardship could dispense with it, compensating instead with a good deed such as feeding a poor person (2:184–5).[42]

As Islam expanded, it was brought into contact with different cultures and this made it necessary for Islamic jurisprudence to produce legislation on problems for which there were no clear legal precedents to follow. The principles of Islamic jurisprudence (usul el fiqh) provide for a set of elaborate rules to interpret the Shariah. But the existence of such complex rules did not preclude adaptive mechanisms. The principle of *talfiq* ('patching') would for example authorize judges to choose an interpretation from schools of jurisprudence other than their own if it seemed to fit the particular circumstances of the case.

More generally, three principles allow for departures from existing norms: local custom (urf), the public interest (maslaha), and necessity (darura). The Shariah can thus be accommodated to societal developments, and allow for innovation, exceptions and loopholes – provided they are properly justified.

We already saw how in administering justice during the Umeyyad era, the governors took into account the existing customs and laws of newly conquered territories, and how the cosmopolitanism of the Abbassid era resulted in considerable diversity. With the weakening of Arab influence in later centuries, syncretism was unavoidable. To put it differently, the farther removed in time and space from early Islam and its birthplace, the stronger the likely influence of indigenous customs.

And as Islam encountered new challenges, especially following its nineteenth-century encounters with capitalism and the West, the concept of *maslaha*, translated as the general good or public interest, was frequently invoked. Based on that classical principle, a jurist confronted with rival interpretations of a passage from the Koran or the Hadith can choose the one he deems most conducive to human welfare. Islamic modernists such as Muhammad Abduh and Rashid Rida made maslaha the key principle for deciding the law where the Koran and the Hadith gave no clear guidance. The principle of talfiq, combined with independent ijtihad, was extended to allow a systematic comparison of all classical schools of laws and to reach a synthesis that would combine their best features. Some fuqaha have argued that the general interest could even override a revealed text.[43] So regardless of how far they have been willing to go, Muslim thinkers have had wide latitude to reason independently from first principles, and a modern Muslim nation could thus enact 'a system of just laws appropriate to the situation in which its past history has placed it'.[44]

A related concept is that of *darura*, or overriding necessity. Otherwise

questionable innovations could be justified by the notion, tacitly accepted by all fiqh schools, that 'necessity permits the forbidden' (al-darura tubih al-mahzurat). In its dietary injunctions for example, the Koran specifically authorizes transgressions caused by necessity (2:173).[45] On various occasions, the Koran has disavowed any divine intent to cause hardship (2:286).[46] The doctrine originally related to individual behaviour. For example, a person who would otherwise starve could be allowed to eat pork. A version of the doctrine holds that a mere 'need' (haja), if it affects many, may be treated like a dire necessity affecting only one.[47] In Iran, the scope of darura was considerably expanded. It has been invoked to waive the primary rulings of Islam if the very existence of the state was threatened, or, in the words of the Ayatollah Khomeini, in instances where inaction would lead to 'wickedness and corruption'.[48]

This has happened frequently in Iran since the Islamic revolution. The landmark 'temporary cultivation agricultural land' bill, transferring ownership of properties from their legal owners to those who had seized them following the revolution, was justified on the grounds of 'zarura' (Persian transliteration of darura). The bill acknowledged that the government would be dispossessing those who had legal title to the land, but this was justified because the alternative was even less satisfactory. In the debate, necessity itself (the impracticality of removing farmers from the land they occupied) was often conflated with criteria such as fairness and justice and with political considerations such as retribution against the *ancien régime*.[49]

More generally, frequent departures from doctrine have occurred since the revolution, and considerable interpretive leeway was allowed to political leaders. On private property issues, the Iranian constitution requires property to meet three conditions: that ownership must 'not go beyond the bounds of Islamic law', that the property itself 'should contribute to the economic growth and progress of the country', and that the property must not 'harm society'. The crucial matter is one of interpretation as to what 'contributes to economic growth and progress' or to 'what harms society'. On such issues, considerable latitude was left to the Majlis (Parliament), which remains in a position to confiscate property arbitrarily.[50]

In a global economy, the overriding necessity of 'the markets' often prevail over tradition and doctrine. In Saudi Arabia for example, Islamic courts had until recent years tended to side with defaulting borrowers against creditor banks. So Saudi banks, invoking the credibility of the country in international financial markets, obtained that the government revive and expand an independent secular court to hear financial cases. Subsequently, Saudi Arabia used this reputation for fair play to borrow heavily on international markets.[51]

In financial matters, darura has been invoked to justify interest on loans, on the grounds that Muslims had to be able to compete with other peoples

who were not bound by the same strictures.[52] Keeping interest-bearing balances in foreign banks could also be justified since such were the norms and practices of the international economy. Similarly, the 'necessity' of economic development has been invoked in the Egyptian fatwas authorizing interest.[53] Typically however, those fatwas invoking darura add that certain types of unlawful profit should be 'purified', that is, used for religiously meritorious purposes, that Muslims should work toward finding an Islamically acceptable alternative, and that when this is accomplished, the raison d'être for granting a dispensation will be extinguished.

2.4 Reconciling Homo Islamicus and Homo economicus

The most important difference between Homo Islamicus and Homo Economicus is the assumption of altruism. As with other pre-capitalist systems, Islam is preoccupied with the welfare of a community where every individual behaves altruistically and according to religious norms.

One of the most significant intellectual developments of the modern era was the new thinking that accompanied and inspired capitalism and the industrial revolution, and came to constitute the basic proposition of the 'science' of political economy in the eighteenth and nineteenth centuries – and later of the discipline of economics. At a time when the Christian ethic emphasized the pursuit of private virtue and the merits of selfless behaviour, a number of thinkers turned the logic on its head: acknowledging the 'dark side' of human nature, they argued in favour of 'pitting greed against greed', of 'turning private vices into public virtues' and of letting 'interests' rather than 'passions' rule.[54] In dealing with the age-old issue of scarcity, this intellectual movement stressed the role of selfish and rational individuals. The central proposition of free market economics is that by pursuing their own self-interest, people confer countless benefits on one another. In the famous formulation of Adam Smith (1723–90), 'It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest'.[55]

For its critics, the major flaw of Islamic economics is the assumption of altruism. In the words of Timur Kuran:

> The primary role of the [behavioral norms of Islam] is to make the individual member of Islamic society, homo islamicus, just, socially responsible, and altruistic. Unlike the incorrigibly selfish and acquisitive homo economicus of neoclassical economics, homo islamicus voluntarily foregoes temptations of immediate gain when by doing so he can protect and promote the interests of his fellows.[56]

The core problem of political economy, that of scarcity in a world of self-interested actors, is abolished by assumption since it is solved by the

diffusion of selfless behaviour. Richards and Waterbury write: 'The Islamist position is that harmony and social order will be achieved by the promotion of individual virtue – by individuals' altering their behavior to conform with Divine Revelation'.[57] Insofar as God has created everything in the right amounts to meet human needs, scarcity is an unnatural condition caused by greed and avarice. Under normal circumstances, altruism, sobriety and virtue are expected, all the more so since the human being is God's 'Khalifah', or vicegerent on earth (2:30)[58] and the resources at his disposal are only a temporary trust (57:7).[59]

In other words, what is 'economically correct' is not 'Islamically correct', and vice versa. Where one approach sees man as inherently selfish, the other considers him altruistic and virtuous. For economists, Islam does not have a realistic view of human behaviour; for Islamists, economics is founded on the principle of individual self-interest and as such, it glorifies greed and is immoral.

In reality however, the gap between Homo Economicus and Homo Islamicus has proved easy to bridge. For one thing, there is an original area of convergence in that, in some respects, 'Homo Islamicus is a modern incarnation of "the Protestant ethic": an entrepreneur who works hard for material gain and is spiritually pure will be rewarded here on earth in the form of shared profits and social recognition'.[60] In certain Islamic communities, sanctification through hard work is at the core of religion. In Senegal for example, this has been a defining characteristic of the two-million strong Mouride brotherhood. Some of the injunctions of that community are reminiscent of Calvinism as described by Max Weber: 'Let us reject jihad [holy war] and wage jihad against our souls', and 'Work as if you were never going to die, and pray as if you were going to die tomorrow'.[61]

As for modern Islamic economics, distinctions should be drawn between early and later writings on the one hand, and between abstract, theological treatises and more pragmatic, policy-oriented writings on the other hand. The well-reasoned critique by Timur Kuran refers primarily to writings of the 1976–81 period.[62] These were the early years of modern Islamic economics, when economic Islam was mostly theoretical (the Pakistani and Iranian experiments had barely started). The confident tone of the literature owes as much to the untried nature of the solutions proposed as to the euphoric mood of the years following the oil boom, when a New International Economic Order seemed within reach.[63] As the abstract views collided with a harsh reality, Islamic economics became more pragmatic. Subsequent writings on Islamic economics, while not very original, have generally shed their utopian expectations and built bridges to conventional economics. As the case studies in Chapter 6 show, experiments in Islamic economics were influenced more by 'situational factors' than by ideology proper. One recent textbook in Islamic economics offers the following comparison of capitalism and the Islamic economic system:

– under capitalism, human beings are selfish; under the Islamic economic system, human beings are selfish as well as altruistic;

– under capitalism, materialism is the supreme value; under the Islamic economic system, materialism should be controlled;

– capitalism favours absolute private ownership; the Islamic economic system favours private ownership within a moral framework.[64]

In sum, far from being inherently contradictory and irreconcilable, Islamic and conventional economics differ primarily to the extent that the former adds an ethical and social dimension that the latter usually lacks. Another example of the convergence is the fact that rather than some heavenly ideal, it is *falah*, best translated as 'well-being', which is increasingly at the centre of Islamic economics.[65] By one definition, 'Islamic economics aims at the study of human falah achieved by organizing the resources of the earth on the basis of cooperation and participation.'[66] Although incorporating moral as well as material well-being, falah refers to the welfare of the community. This new focus, combined with the justifications of darura and maslaha, could pave the way for further convergence between Homo Islamicus and Homo Economicus.

This more pragmatic brand of Islamic economics is not fundamentally different from 'Keynesian' approaches (which in a broad sense include socio-economics, institutionalism and other approaches seeking to alleviate the excesses of the market through state intervention), or from attempts by Christian, Jewish or even secular thinkers to inject an ethical dimension to free-market economics by tempering the unbridled pursuit of self-interest with certain social and moral values. Paradoxically, at a time when unfettered free markets have triumphed, attempts at 'balance' (between state and market, between individual rights and social obligations) have been increasingly common.[67]

Contemporary debates on political economy can be situated on a continuum where the two extremes are a pure free market and absolute government control. Most ethical and religious systems reject this polarization and invoke a 'third way' or a 'middle ground'. History has shown that such a 'middle ground' can accommodate a range of opinions, and that such 'middle ground' can shift at different times and in different places. The Catholic Church has historically been able to accommodate both left-wing 'liberation theology' and right-wing conservatives. In recent years, with the triumph of the free-market ideology, many religious thinkers have seen no contradiction between religious teachings and the defence of the free market. Catholic theologian Michael Novak has launched a strong moral defence of capitalism, noting that, 'like prudence in Aristotelian thought, self-interest in democratic capitalist thought has an inferior reputation among moralists'. Arguing that 'self-interest' is not synonymous with greed or acquisitiveness, he proposed a definition that

would encompass 'religious and moral interests, artistic and scientific interests, and interests in peace and justice', as well as concern for the well-being of one's family, friends and country.[68]

Islamic economic thinking has evolved along a similar tack. Whereas in the sixties, many Islamic intellectuals emphasized the compatibility of Islam with socialism and, for some, even with Marxism, many influential economists today emphasize the affinities between Islam and the free-market ideology. Since dubious intentions could combine to produce beneficial results – welfare and especially progress toward meeting the needs of the poor[69] – the system could be morally justifiable, and indeed perhaps morally superior to well-meaning but ineffectual policies.[70] It is revealing that the first major attempt at full Islamization of an economy – in Pakistan under President Zia in 1977 – was part of a neo-liberal economic package. Even more striking, in the Sudan of 1992–3, Islamists have openly and unapologetically embraced the most extreme form of neo-liberalism, under the stewardship of Abdul Rahim Hamdi, a Minister of Finance (and Islamic banker) who was influenced by the ideas of Milton Friedman. He defended free-market rules on the grounds that 'this is how an Islamic economy should function'. He even argued that '[t]he population accepts these hardships because it supports Islam and us'.[71]

In sum, the 'Homo Economicus' vs. 'Homo Islamicus' contrast is now largely irrelevant. Both represent, if not a utopia (literally meaning 'no place') at least an ideal.[72] Both are normative rather than descriptive. Homo Islamicus states what people should strive towards, as opposed to how people are likely to behave (the 'ought' as opposed to the 'is').[73] Homo Economicus similarly represents an idealized free market, one that works only under certain assumptions. As noted by Alan Richards and John Waterbury, 'It is well to remember that policymaking practice *never* conforms to rigorous theory.'[74] Much to the dismay of fundamentalists of all stripes, the 'real economy', though it may be inspired by a given ideology, is also likely to stray from that ideology.

In fact, insofar as the economic profession can be regarded as a learned class devoted to the defence of the free-market system,[75] one can see obvious parallels between the guardians of the dogma in both Islam and economics: intolerance toward dissident or 'incorrect' views, territoriality, focus on arcane and sterile debates, etc. Reading Paul Krugman's diatribes against the encroachments of those who are not 'trained economists' or Robert Barro's or Milton Friedman's denunciations of the sins committed by 'politicians' against the free market, one recognizes a tone the Western press usually associates with 'ayatollahs'.[76] One can even see religious overtones in 'economic fundamentalism'.[77] Rodney Wilson wrote about the preoccupation of economists with 'pure' equilibrium:

> The economic order is … permanent, and should reflect the divine order … [S]ome of the language and symbolism – perfect markets,

> the concept of equilibrium, efficiency in transactions which implies perfect knowledge – all perhaps unconsciously, could be viewed as striving for some heavenly ideal.[78]

And Bernard Maris remarked that abstract economics possesses 'the same essence as theology insofar as both are based on compilation and gloss, commentary and the deepening of commentary'.[79] Just as those who inhabit a highly formalized world of perfect competition, perfect information and perfect rationality seek to eliminate imperfections (such as the existence of a public sector, which in most countries accounts for nearly half of the Gross Domestic Product), so Islamic purists seek to eliminate selfish motives in a world dominated by altruism and virtue. Just as one can find absurd prescriptions in the writings of religious fundamentalists, so one can find equally absurd policy prescriptions made by economic fundamentalists.[80]

2.5 Reconciling Islam and Finance

The Koran states that despite their superficial resemblance, profits from commerce are fundamentally different from profits from money-lending (2:275).[81] Unlike Christians who have long denigrated all business endeavours, Muslims have traditionally looked favourably at commerce, while being suspicious towards finance. As Chapters 3 and 12 show, the reconciliation between Christianity and finance, and for that matter between Christianity and business in general, was long-drawn and fraught with theological and philosophical disputes.

In Islam, although riba would occasionally be interpreted not as interest, but as usury (or excessive interest), strict definitions have typically prevailed. But as its economy grew more complex, the Islamic world was able to find proper substitutes, justifications, or subterfuges. In the early years of Islam, jurists devised an impressive array of contracts designed to circumvent riba, the most important ones being profit-and-loss sharing contracts (mudaraba or qirad).[82] Some of these contracts were in fact so clever as to be considered *hiyal* (sing.: *hila*), meaning ruses or wiles; that is, lawful means used, knowingly and voluntarily, to reach an unlawful objective. Provided that certain formalities were used, interest, albeit by a different name, could be charged and paid. Certain schools of jurisprudence – in particular the Hanafis and Shafiis – took a tolerant view of such hiyal,[83] and entire treatises were written, detailing how Muslims could use such contrivances while staying on the right side of the Shariah. It was thus a form of casuistry (looking at a specific 'case' to prove that the general rule of behaviour does not apply). One of those 'hiyal', the 'mohatra contract', is mentioned in Blaise Pascal's eighth 'Lettre Provinciale' (1656) as representative of the casuistic reasoning of Jesuits.[84]

The mohatra refers to the ancient double sale also known as ina or mukhatara, where a borrower and a lender arrange to sell and then resell between them a trivial object, once for cash and once for a greater sum on credit, with the net result being a loan with interest.[85] There is disagreement among scholars as to how common such devices were. Maxime Rodinson has found them to be very common, while others argue that he overstated the case.[86] Then, of course, there was the possibility of circumventing riba by dealing with non-Muslim (mostly Jewish) money-lenders, a common practice since the Abbassid era.

Modern finance entered the Islamic world alongside Western colonial expansion.[87] Foreign banks financed trade and development, and in due course Islamic governments, strapped for cash, had become debtors, therefore paying interest to foreign creditors. The Ottoman empire since 1840 had been issuing interest-bearing Treasury Bonds,[88] but it is in Egypt that foreign bankers played a crucial role.[89] Egypt's role in legitimizing modern finance cannot be overemphasized. It was the first Islamic country to possess indigenously controlled banks. The National Bank of Egypt was created in 1898 with mixed capital (50 per cent was in Egyptian hands). In 1920, Banque Misr was established, the first ever to be formed exclusively with local capital. Egypt's thriving stock-market made it a favourite among early twentieth-century 'emerging' markets. (At one point in the highly unusual context of the period following the end of World War II, Egypt had the third largest stock market in the world.[90]) Egypt's legal code, which was French-inspired, allowed interest not exceeding seven per cent, and served as a model for many Arab codes. Perhaps most importantly, it is in Egypt that interest was legitimated by religious authorities in 1904. In a famous if controversial fatwa, mufti Sheikh Muhammad Abduh, a leading figure of Islamic reform, cautiously legitimated interest generated either by savings bank accounts or by insurance policies.[91]

The riba controversy was temporarily ignored but not put to rest. Many legal codes adopted by Islamic countries observed an 'eloquent silence' – to use Maxime Rodinson's formulation – on the issue of interest-bearing loans. Overall, interest was tolerated, although it was not uncommon for devout Muslims to refuse interest on their savings. The world of finance took a new turn with the end of colonialism. Newly independent states established national monetary authorities and central banks, and issued local currencies. Control over the credit system and thus over interest rates was perceived as a crucial part of development and economic policy, especially where banks had been nationalized (in countries such as Egypt, Syria, Iraq, Algeria, South Yemen, Libya, and the Sudan). In short, until recent attempts at 'Islamicizing' economic systems, all countries, regardless of ideological leanings, learned to live with interest and with modern finance. Custom, necessity and the public interest helped overcome the age-old suspicion towards debt and practices such as insurance.[92] With the

advent of Islamic finance, the prevailing consensus among Islamic scholars was that dealing with conventional banks was acceptable if Islamic institutions were not accessible to them. As for the issue of Muslims or Islamic institutions benefiting from interest, opinions and practices have varied. Some Islamic institutions have steadfastly refused to receive interest, whereas others, including the Islamic Development Bank and the Faisal Islamic Bank of Egypte (FIBE), have always placed their excess funds in interest-bearing accounts, usually overseas.[93] Three theological arguments have typically been invoked to justify receiving interest. One was the overriding necessity argument: given the developmental needs for Muslims, taking interest was justified. Another was based on the old distinction between 'Dar Al Harb' (literally the 'realm of war'), that is, non-Muslim countries, and the realm of Islam ('Dar Al Islam'). It would then be permissible to profit from interest in dealings with Dar Al Harb, especially since this would strengthen the relative position of Dar Al Islam. A third, more frequent position was that income from interest could be accepted, but that it should be 'purified', that is, earmarked for charitable purposes.

Islamic revivalism has to some extent led, along with the Islamicization of economic systems (in Pakistan, Iran and the Sudan), to a re-examination of riba and gharar. But as Chapter 6 shows, even those countries that have 'eliminated interest' have developed interest-like mechanisms, and still have significant components of their economies operating on the basis of conventional interest. The transformation of modern finance that has taken place since the 1980s has also reopened the debate about the acceptability of new financial instruments. But rather than a wholesale rejection, the trend has been towards a new ijtihad designed to separate those products that are acceptable from those that are not, and to create financial instruments adapted to the needs of Islamic societies.[94]

Notes

1. Aziz Al-Azmeh, *Islam and Modernities*, London: Verso 1993, p. 12.
2. At one extreme end of the spectrum, some have gone so far as to argue that only the Meccan part of the Koran was binding. See William E. Shepard, 'Islam and Ideology: Towards a Typology', *International Journal of Middle East Studies* 19 (1987), p. 312.
3. See Nicholas Heer (ed.), *Islamic Law and Jurisprudence*, University of Washington Press 1990; Wael B. Hallaq, *A History of Islamic Legal Theories: An Introduction to Sunni Usul Al Fiqh*, Cambridge University Press 1997; C. G. Weeramantry, *Islamic Jurisprudence: An International Perspective*, New York: St. Martin's Press 1988.
4. Henri Laoust, *Les Schismes dans l'Islam*, Paris: Payot 1965.
5. Philip K. Hitti, *Syria: A Short History*, New York: Macmillan 1959, p. 115.
6. Albert Hourani, *A History of the Arab Peoples*, Harvard University Press 1991, p. 66.
7. Hourani, p. 161.
8. Wael B. Hallaq, 'Was the Gate of Ijtihad ever closed?', *International Journal of Middle East Studies* 16 (1984), pp. 1–33.

9. Joseph Schacht, *An Introduction to Islamic Law*, Oxford University Press 1964, p. 70.
10. Edward Mortimer, *Faith and Power: The Politics of Islam*, New York: Random House 1982, p. 37.
11. Olivier Carré, *L'Islam laïque ou le retour à la Grande Tradition*, Paris: Armand Colin 1993.
12. Bernard Lewis, *Islam and the West*, Oxford University Press 1993, p. 13.
13. John O. Voll, 'Renewal and Reform in Islamic History: *Tajdid* and *Islah*', in John L. Esposito (ed.), *Voices of Resurgent Islam*, Oxford University Press 1983, pp. 32–47.
14. Carré, 1993.
15. Edward Said, *Orientalism*, New York: Random House 1979.
16. Albert Hourani, *Europe and the Middle East*, University of California Press 1980, p. 10.
17. John O. Voll, *Islam: Continuity and Change in the Modern World*, Boulder, Colo.: Westview Press 1982, p. 33.
18. Yahya Sadowski, 'The New Orientalism and the Democracy Debate', in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 43.
19. Malcolm Kerr, *Islamic Reform: the Political and Legal Theories of Muhammad Abduh and Rashid Rida*, University of California Press 1966.
20. Mortimer, p. 115.
21. Max Weber, *The Protestant Ethic and the Spirit of Capitalism*, Englewood Cliffs, N.J.: Prentice Hall 1980.
22. Koran 2:198 'It is no sin for you that you seek the bounty of your Lord. So when you press on from Arafat, remember Allah near the Holy Monument, and remember Him as He has guided you, though before that you were certainly of the erring ones'. (Reference to commercial activities in Mecca during Pilgrimage.)

    73:20 'Thy Lord knows indeed that thou passes in prayer nearly two-thirds of the night and [sometimes] half of it, and [sometimes] a third of it, as do a party of those with thee. And Allah measures the night and the day. He knows that [all of] you are not able to do it, so He has turned to you [mercifully]; so read of the Koran that which is easy [for you], keep up prayer and pay the poor-rate and offer to Allah a goodly gift. And whatever of good you send on before hand for yourselves, you will find it with Allah – that is best and greatest in reward. And ask forgiveness of Allah. Surely Allah is forgiving, merciful'.
23. Koran 62:9 'O you who believe, when the call is sounded for prayer on Friday, hasten to the remembrance of Allah and leave off traffic. That is better for you, if you know'.

    62:10 'But when the prayer is ended, disperse abroad in the land and seek Allah's grace, and remember Allah much, that you may be successful'.
24. Ira M. Lapidus, *Muslim Cities in the Later Middle Ages*, Harvard University Press 1967.
25. Muhammad Akram Khan, *An Introduction to Islamic Economics*, Islamabad: International Institute of Islamic Thought and Institute for Policy Studies 1994, p. 83.
26. Chibli Mallat, *The renewal of Islamic law: Muhammad Baqer as-Sadr: Najaf and the Shi'i International*, Cambridge University Press 1993, p. 111.
27. William E. Shepard, 'Muhammad Sa'id Al-Ashmawi and the Application of the Shari'a in Egypt', *International Journal of Middle East Studies* 28 (1996), pp. 39–58.
28. Myron Weiner and Samuel P. Huntington (eds), *Understanding Political Development*, Boston: Little, Brown and Company 1987.

29. Timur Kuran, 'Economic Justice in Contemporary Islamic Thought', *International Journal of Middle East Studies* 21:2, May 1989, pp. 171–91.
30. In those years competition between pan-Arabism and pan-Islamic usually pitted Egypt against Saudi Arabia (see Chapter 5), although there were periods of *rapprochement* between the two countries.
31. John L. Esposito (ed.), *Voices of Resurgent Islam*, Oxford University Press 1983, p. 9.
32. Khalid M. Ishaque, 'The Islamic Approach to Economic Development', in John L. Esposito (ed.), *Voices of Resurgent Islam*, Oxford University Press 1983, pp. 268-76.
33. See Chapter 5.
34. Timur Kuran, 'The Economic System in Contemporary Islamic Thought: Interpretation and Assessment', *International Journal of Middle East Studies* 18 (1986), p. 135.
35. Rodney Wilson, *Economics, Ethics and Religion: Jewish, Christian and Muslim Economic Thought*, New York University Press 1997, p. 115.
36. Mallat, p. 111.
37. Mallat, pp. 117–20.
38. Traute Wohlers-Scharf, *Arab and Islamic Banks: New Business Partners for Developing Countries*, Paris: OECD 1983, p. 91.
39. Khan, p. 30.
40. John L. Esposito, *The Islamic Threat: Myth or Reality?*, Oxford University Press 1992, p. 80.
41. Mallat, p. 125.
42. Koran 2:184 'But whoever among you is sick or on a journey, [he shall fast] a like number of other days. And those who find it extremely hard may effect redemption by feeding a poor man. So whoever does good spontaneously, it is better for him; and that you fast is better for you if you know'.

    2:185 'The month of Ramadan is that in which the Koran was revealed, a guidance to men and clear proofs of the guidance and the Criterion. So whoever of you is present in the month, he shall fast therein, and whoever is sick or on a journey, [he shall fast] a [like] number of other days. Allah desires ease for you, and He desires not hardship for you, and [He desires] that you should complete the number and that you should exalt the greatness of Allah for having guided you and that you may give thanks'.
43. Carré, p. 15.
44. Mortimer, p. 244.
45. Koran 2:173 'Allah has forbidden you only what dies of itself, and blood, and the flesh of swine, and that over which any other name than that of Allah has been invoked. Then whoever is driven by necessity, not desiring, nor exceeding the limit, no sin is upon him. Surely Allah is forgiving, merciful'.
46. Koran 2:286 'Allah imposes not on any soul a duty beyond its scope. For it is that which it earns [of good] and against it that which it works [of evil]. Our Lord, punish us not if we forget or make a mistake. Our Lord, do not lay on us a burden as Thou didst lay on those before us. Our Lord, Impose not on us afflictions which we have not the strength to bear. And pardon us! And grant us protection! And have mercy on us! Thou art our Patron, so grant us victory over the disbelieving people'.
47. Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk, and Return*, The Hague: Kluwer Law International 1998, p. 38.
48. Shaul Bakhash, 'The Politics of Land, Law, and Social Justice in Iran', *Middle East Journal*, Vol. 43, No. 2, Spring 1989, p. 196.
49. Bakhash, 1989.
50. Jahangir Amuzegar, *Iran's Economy Under the Islamic Republic*, London: I. B.

Tauris 1993, pp. 21–8.
51. Kiren Aziz Chaudhry, *The Price of Wealth: Economies and Institutions in the Middle East*, Cornell University Press 1997, p. 37.
52. Mortimer, p. 245.
53. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*, Paris: Presses Universitaires de France 1997, p. 43.
54. Albert Hirschman, *The Passions and the Interests: Political Arguments for Capitalism Before Its Triumph*, Princeton University Press 1977.
55. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, University of Chicago Press 1977.
56. Kuran 1986, p. 136.
57. Alan Richards and John Waterbury, *A Political Economy of the Middle East*, Boulder, Colo.: Westview Press 1996, p. 354.
58. Koran 2:30 'And when thy Lord said to the angels, I am going to place a ruler in the earth, they said: Wilt thou place in it such as make mischief in it and shed blood? And we celebrate Thy praise and extol Thy holiness. He said: Surely I know what you know not'.
59. Koran 57:7 'Believe in Allah and His Messenger and spend of that whereof He has made you heirs. So those of you who believe and spend – for them is a great reward'.
60. Karen Pfeifer, 'Is there an Islamic Economics?' in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 163.
61. Sophie Bava and Danielle Bleitrach, 'Islam et pouvoir au Sénégal: Les mourides entre utopie et capitalisme', *Le Monde diplomatique*, November 1995.
62. Kuran 1986, pp. 135–64.
63. See Chapter 5.
64. Khan, p. 26.
65. Khan, pp. 34–44.
66. Khan, p. 33.
67. See Ellen Frankel Paul, Fred D. Miller, Jr, and Jeffrey Paul (eds), *Ethics and Economics*, London: Basil Blackwell 1985; Amitai Etzioni, *The Moral Dimension: Towards a New Economics*, New York: Free Press 1988.
68. Michael Novak, *The Spirit of Democratic Capitalism*, Lanham Md.: Madison Books 1991.
69. Michael Novak, *The Catholic Ethic and the Spirit of Capitalism*, New York: Free Press 1993; Richard John Neuhaus, *Doing Well and Doing Good*, New York: Doubleday 1993.
70. See for example, Muhammad Akram Khan, *An Introduction to Islamic Economics*, Islamabad: International Institute of Islamic Thought and Institute of Policy Studies 1994, pp. 33–90.
71. Judith Miller, *God Has Ninety-Nine Names: A Reporter's Journey through a Militant Middle East*, New York: Simon and Schuster 1996, p. 144.
72. *Utopia* is also the title of the famous book by Thomas More (1516), about an imaginary island that represented moral, political and social perfection.
73. Mohammed N. Siddiqi, *Muslim Economic Thinking*, Leicester: The Islamic Foundation 1981, p. 69.
74. Richards and Waterbury, p. 356.
75. Peter E. Earl, 'A Behavioral Theory of Economists' Behavior', in Alfred S. Eichner, *Why Economics is not yet a science*, Armonk, N.Y.: M. E. Sharpe 1983.
76. Paul Krugman, *Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations*, New York: W. W. Norton 1994; Robert J. Barro, *Markets and Choices in A Free Society*, MIT Press 1996; and Milton Friedman, *Capitalism and*

Freedom, University of Chicago Press 1963; see also the exchange between James K. Galbraith and Paul Krugman, 'Who's the Real Economist?' in *Slate*, 7 and 11 November 1996.
77. George Soros, *The Crisis of Global Capitalism*, New York: Public Affairs 1998.
78. Wilson, p. 45.
79. Bernard Maris, *Des Economistes au-dessus de tout soupçon, ou la grande mascarade des prédictions*, Paris: Albin Michel 1990, p. 57.
80. Ibrahim Warde, 'La vie, la mort, le marché', *Le Monde diplomatique*, June 1998.
81. See Chapter 3.
82. Abraham Udovitch, *Partnership and Profit in Medieval Islam*, Princeton University Press 1970.
83. Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, gharar and Islamic banking*, Cambridge University Press 1986.
84. Blaise Pascal, *Les Provinciales ou Les Lettres écrites par Louis de Montalte à un provincial de ses amis et aux RR. PP. Jésuites sur le sujet de la morale et de la politique de ces Pères*, Paris: Gallimard Folio 1987, p. 131.
85. Vogel and Hayes, p. 39.
86. Maxime Rodinson, *Islam and Capitalism*, London: Penguin, p. 48, and Galloux, p. 18.
87. Charles Issawi (ed.), *The Economic History of the Middle East 1800–1914*, University of Chicago Press 1966, pp. 10–11.
88. Historians however disagree on the amount of interest charged. Estimates vary between eight and twelve per cent. Rodinson, p. 144.
89. David Landes, *Bankers and Pashas: International Finance and Economic Imperialism in Egypt*, Harvard University Press 1958.
90. *Worth*, December 1996–January 1997.
91. Chibli Mallat, 'The debate on riba and interest in twentieth century Egypt', in Chibli Mallat (ed.), *Islamic Law and Finance*, London: Graham and Trotman 1988, pp. 69–88.
92. Mortimer, p. 238.
93. Elias Kazarian, *Islamic Versus Traditional Banking: Financial Innovation in Egypt*, Boulder: Westview Press 1993, p. 225.
94. Vogel and Hayes, pp. 235–95.

3

RIBA, GHARAR, AND THE MORAL ECONOMY OF ISLAM IN HISTORICAL AND COMPARATIVE PERSPECTIVE

Most definitions reduce Islamic banking to 'interest-free' banking. While the injunctions against riba are indeed the cornerstone of Islamic finance, debates persist as to the exact significance of the word. Since the early days of Islam, the majority of scholars have adopted a restrictive definition: any form of interest constitutes riba. The debate is nonetheless still lively. A few voices – including those of prominent figures such as the Egyptian mufti, Muhammad Sayyed Atiyya Tantawi, now Shaikh of Al-Azhar, one of Islam's oldest and most prestigious learning centres – have rejected that definition and argued that Islam tolerates a reasonable rate of interest. This chapter starts with the riba debate, its origin and significance. It later discusses gharar, a lesser known yet – in the contemporary world of finance – equally significant prohibition, the moral economy of Islam, a broader approach focusing on the spirit, as opposed to the letter of Islam, and the religious vs secular approaches to these issues. The final section places the money and religion debate in comparative and historical perspective.

3.1 Riba

The controversy over riba shows no sign of abating. Some have condemned attempts to even discuss the matter. One scholar wrote:

> If Quranic theories come into conflict with the modern scientific theories, I find no reason to trouble my conscience. I firmly believe that the sciences of today may become the mythology of tomorrow and what Quran has said, we may not understand it today, but it is likely to become quite clear to us tomorrow.[1]

At the other end of the spectrum, a few have dismissed the 'entire medieval notion of riba as an obsolete idea'.[2]

The riba debate has been approached from many angles. One set of discussions contrasts 'interest', a moderate, economically justified remuneration of capital, with 'usury', an excessive, sometimes extortionary rate. A few scholars have argued that only the latter constitutes riba. The majority of Islamic scholars still consider that any increase in the amount of money

returned by a borrower constitutes riba and is therefore prohibited.

Another angle is the requirements of the modern economy. In recent decades, darura (necessity) and maslaha (the general interest), as well as existing practices and customs have been repeatedly invoked by Islamic modernists.[3] In the words of Fazlur Rahman:

> As long as our society has not been reconstructed on the Islamic pattern, it would be suicidal for the economic welfare of the society and the financial system of the country and would also be contrary to the spirit and intentions of the Quran and Sunna to abolish bank-interest.[4]

By the same token, some have raised the issue of the inflationary nature of the contemporary economy. The prohibition of riba would then apply to real interest (that is, the interest rate minus the rate of inflation) as opposed to nominal interest. Otherwise, the absence of interest in an inflationary period would amount to negative real interest, which would penalize lenders and subsidize borrowers.[5]

In the same vein, some have argued that the concept of riba had been misunderstood, misinterpreted and misapplied. Mohammed Said al-Ashmawi makes three arguments to show that a sweeping prohibition against interest is unwarranted: first, in his view, the riba referred to in the Koran was the riba al-jahiliyya (see below), which refers to the common pre-Islamic practice of doubling the principal[6] in exchange for more time, and which resulted in the enslavement of the borrower if in the end he could not pay; second, riba – based on a widely quoted Hadith – specifies six commodities, and should apply only to these six, and not to modern currency;[7] third, a distinction should be drawn between economically useful loans, such as those taken by businesses and institutions for the purpose of investing and making profit, and exploitative loans such as those made to poor individuals to help them meet immediate basic needs.[8]

In contrast, certain scholars have claimed that a modern economy could bypass riba altogether by devising appropriate mechanisms.[9]

Rather than resolving the issue, a number of fatwas have perpetuated the controversy. In 1904, in a context of rapid economic change, Egypt's mufti, the reformer Muhammad Abduh, issued, by request of the government, a controversial fatwa on the Egyptian Savings Fund (Sanduq al-Tawfeer) created by the Postal Administration. In exchange for cash deposits, the Egyptian Savings Fund had issued savings 'certificates' which yielded depositors a fixed and predetermined rate of return on their money. The Savings Fund used such deposits for various small investments. The fatwa adopted, albeit carefully, a tolerant view of fixed and predetermined rates.[10] Ambivalence and hedging have since characterized such decisions. As was observed by Chibli Mallat:

> Egyptian muftis writing in the 20th century acknowledge that they are treading a delicate path and are dealing with powerful economic actors and institutions that have strong supporters in new, as well as in established, commercial sectors. Because a fatwa that unilaterally condemned interest-bearing transactions would be totally ineffective, most muftis have taken care to formulate their opinions in language that is either cautious or ambiguous.[11]

Despite attempts at 'balance', disagreements have not subsided. In 1986, the Fiqh (jurisprudence) Academy of the Islamic Conference supported the restrictive interpretation of early jurists, condemning all interest-bearing transactions as void.[12] But in 1989, while an economic and rhetorical debate between Islamic financial institutions and conventional banks was raging (in the wake of the collapse of Islamic Money Management Companies [IMMCs]),[13] the mufti of the Egyptian Republic, Muhammad Sayyed Atiyya Tantawi, issued what he considers his most important fatwa, one legitimizing 'capitalization certificates' (shahadat al-istithmar), which are interest-bearing government bonds underwritten by Egyptian banks. To justify his position, he cited jurists as well as bankers and secular experts. He argued 'that the determination of the profit in advance is for the sake of the owner of the capital (that is deposited) and is done to prevent a dispute between him and the bank.'[14] In addition, since the certificates are issued in connection with the state's financing of the development plan in order to encourage the population to increase its level of savings, the certificates legally are not loans, but deposits. Despite the traditional pre-eminence of Egyptian Grand Muftis within the Islamic – especially Sunni – world, many leading figures therein remained unconvinced. Thus a decision of the Federal Shariat Court of Pakistan dismissed that fatwa in 1992 as the 'solitary opinion of Shaikh Tantawi of Egypt'.[15]

On other occasions, Tantawi launched frontal attacks against Islamic banks, accusing them of hypocrisy and of misleadingly using the word Islam in their appellation. In a 1995 speech, he criticized Western-style banks which established 'Islamic' subsidiaries to meet the growing demand for such services. He said that there was little difference between Western-style banks which offer fixed interest rates, and Islamic banks in which depositors share the risk of investing in projects, for Islam simply requires financial transactions to be marked by 'clarity and justice'. Even more provocatively, he argued that 'banks which set fixed interest are closer to Islam because they make clear people's entitlement'.[16]

Tantawi's successor as mufti, Sheikh Nasr Farid Wassel, took the same position, declaring: 'I will give you a final and decisive fatwa: so long as the banks invest the money in halal, then the transaction is halal.' He called for an end to the controversy about bank interest, adding that 'there is no such thing as an Islamic and non-Islamic bank'.[17]

Egypt is in a singular position in the Islamic world. On the one hand, it played a pioneering role in Islamic finance and hosts some of the best-known Islamic institutions. Also, most of its conventional banks offer Islamic products. Yet the country's top religious establishment has legitimated moderate interest and in effect considers Islamic institutions superfluous and questionable. The Egyptian fatwas had a paradoxical impact on Islamic finance, insofar as they added legitimacy to more pragmatic approaches, but the intellectual debate on riba is still raging. It is all the more inconclusive that unassailable, factual elements about the origin of riba are scarce.

It is generally agreed that Mohammed's view evolved from exhortation against riba in his 'Mecca period' to outright prohibition in his 'Medina period'. The Koran declares that those who disregard the prohibition of riba are at war with God and his Prophet. That prohibition is explicitly mentioned in four different revelations of the Koran (2:275–81, 3:129–30, 4:161 and 30:39), expressing the following ideas: despite the apparent similarity of profits from trade and profits from riba, only profits from trade are allowed; when lending money, Muslims are asked to take only the principal and forgo even that sum if the borrower is unable to repay; riba deprives wealth of God's blessings; riba is equated with wrongful appropriation of property belonging to others; Muslims should stay away from it for the sake of their own welfare.[18] But the Koran does not elaborate further. A few of Mohammed's companions even expressed frustration at the vagueness of the definition.

The Hadith however is more specific, distinguishing two types of riba: riba al-fadl, which is produced by the unlawful excess of one of the countervalues, and riba al-nasia, which is produced by delaying completion of the exchange of the countervalues. Early Islamic scholars also mentioned a third type of riba, riba al-jahiliyya (or pre-Islamic riba), which occurs when the lender gives the borrower at maturity date a choice between settling the debt or doubling it.

So, what exactly is riba? Literally, it means increase. Based on that definition, there is in riba both more and less than meets the eye. Riba is not necessarily about interest rates as such, and it certainly is not exclusively about interest rates. It really refers to any unlawful gain derived from the quantitative inequality of the countervalues. Interest or usury (i.e., reimbursing more than the principal advanced) would then be only one form of riba.

Different explanations have been advanced as to why riba is condemned. A few had to do with expediency but most were related to economic/ethical norms. Historian Philip Hitti has, for example, suggested that Mohammed's injunctions against usury were aimed at the Jews of Medina: he badly needed their financial support when they were keen on charging interest on these loans.[19] Yet the very persistence of the

prohibition, well beyond Mohammed's life, suggests concerns beyond mere expediency.

Islamic scholars have insisted that the prohibition of riba is not an isolated religious injunction but 'an integral part of the Islamic economic order with its overall ethos, goals and values'.[20] One needs therefore to look at the 'moral economy' of a 'pre-modern' economic system, where transactions involved various forms of barter and exchange, often completed over time. From such a perspective, one can find striking parallels between early Islam and contemporaneous ethical and religious systems. Following a discussion of gharar, we will dwell on the moral economy of Islam and on those parallels.

3.2 Gharar

With only a few exceptions, the vast majority of the writings on Islamic finance simply ignore gharar.[21] Although the word itself is not mentioned in the Koran, etymologically related words, meaning deception or delusion, are.[22] It is however in a number of Hadiths that gharar is condemned. As in the case of riba, the prohibition is unequivocal though the concept itself is somewhat vague. It should be noted however that certain schools of fiqh tolerate gharar in case of need (haja) and when it cannot be averted except with great difficulty.[23]

The word gharar means deception or delusion but also connotes peril, risk or hazard. In its financial interpretation, it is usually translated as 'uncertainty, risk or speculation'. As explained by Maxime Rodinson:

> Any gain that may result from chance, from undetermined causes, is here prohibited. Thus, it would be wrong to get a workman to skin an animal by promising to give him half the skin as reward, or to get him to grind some grain by promising him the bran separated out by the grinding process, and so on. It is impossible to know for certain whether the skin may not be damaged and lose its value in the course of the work, or to know how much bran will be produced.[24]

Importantly however, gharar should not be used interchangeably with the broad concept of risk. Gharar is prohibited yet it would be nonsensical to prohibit risk. Islam does not even advocate the avoidance of risk. Indeed, incurring commercial risk is approved, even encouraged, provided it is equitably shared. More accurately, gharar refers to aleatory transactions, that is, transactions conditioned on uncertain events. Three passages in the Koran prohibit Maysir,[25] which is usually meant to include all games of chance (2:219, 5:90 and 5:91).[26] In every instance, the prohibition is associated with that against wine drinking. The primary reason for condemning Maysir is that it causes enmity and distracts the faithful from worship.

The Hadith goes much further, extending the concept to commercial transactions involving uncertainty. Among the most significant hadiths are the following:

> – 'The Messenger of God forbade the "sale of the pebble' ["hasah": sale of an object chosen or determined by the throwing of a pebble], and the sale of gharar'.
>
> – 'Do not buy fish in the sea, for it is gharar'.
>
> – 'The Messenger of God forbade the [sale of] the covering [copulation] of the stallion'.
>
> – 'The Prophet forbade sale of what is in the wombs, sale of the contents of the udders, sale of a slave when he is runaway, … and [sale of the] "stroke of the diver" ["darbat al-gha'is": sale in advance of a diver's dive]'.
>
> – 'Whoever buys foodstuffs, let him not sell them until he has possession of them'.
>
> – 'He who purchases food shall not sell it until he weighs it'.
>
> – '[T]he Prophet forbade the sale of grapes until they become black, and the sale of grain until it is strong'.[27]

Based on these Hadiths, Frank Vogel has arranged the prohibitions in a spectrum according to the degree of risk involved: pure speculation, uncertain outcome, unknowable future benefit, and inexactitude. He concluded that:

> [A] possible interpretation of the gharar hadiths is that they bar only risks affecting the existence of the object as to which the parties transact, rather than just its price. In the hadiths, such risks arise either 1) because of the parties' lack of knowledge (jahl, ignorance) about that object; 2) because the object does not now exist; or 3) because the object evades the parties' control. Therefore the scholars might use one of these three characteristics to identify transactions infected by the type of risk condemned as gharar.[28]

3.3 Contemporary Interpretations: Religious and Secular Experts

At a time of revolutionary changes in international finance, it was inevitable that literal, scholastic and legalistic interpretations of the Shariah would clash with pragmatic ones focusing on the spirit of Islam, and likely to invoke maslaha (the general interest) and darura (overriding necessity). Where traditionalists are likely to defer to fiqh scholars, modernists will seek the advice of secular experts. In reality, the world of finance has grown

so complicated that secular experts must be called upon to explain certain instruments and practices, leaving it to Shariah Boards and Islamic financiers to decide whether certain products and practices conform to the spirit of Islam.

In that regard, the 1989 Tantawi fatwa broke new ground. Chibli Mallat explains how the mufti based his decision 'on the basis of the Koran and Hadith, the obligation of wise men to search for the truth, the principle of ijtihad, the virtue of avoiding fanaticism, and *the importance of expertise to unravel arcane subjects'* (my emphasis). Tantawi cited the Koran's injunction to 'ask the ahl al-dhikr if you do not know' (21:7), with ahl al-dhikr defined as 'the people of expertise and experience in all science and art'. The mufti further added, 'in medicine you ask physicians, in fiqh the fuqaha, and in economics you ask economists'.[29]

In what Mallat emphasized was a 'significant and unusual move', the mufti conceded he could not answer questions that fell beyond his area of expertise – he specifically wrote that expertise in the Shariah does not imply familiarity with arcane financial matters – without consulting experts on banking: '[S]cientific trust requires (the mufti) not to issue a fatwa in such matters before asking those who are knowledgeable and possess expertise in these matters, because ruling on an issue requires (the mufti) to fully understand it (literally: ruling on a matter is part of imagining it)'.[30] Accordingly, Tantawi sent detailed questions to the Chairman of the board of Egypt's Ahli Bank, and inserted in his fatwa lengthy quotes from secular specialists. Not only were the opinions of secular experts a factor in the fatwa, but the mufti promised that in the future such consultations would occur to unravel financial matters.[31]

As already noted, the Tantawi fatwa was controversial in the Islamic world. Considering that modern economic and financial orthodoxy has turned old axioms on their heads, we can appreciate the range of controversy among scholars – and better understand the diversity of Islamic finance. Examples of the clash between secular financial orthodoxy and traditional Islamic injunctions on finance abound. On the topic of speculation, the early Islamic tradition roundly and unambiguously condemned gharar. Yet in recent centuries, new approaches towards risk have emerged: by relying on the past and using probabilities and other quantitative techniques, risk could be measured and to some extent tamed.[32] In areas such as insurance or financial derivatives, risk management has become crucial. So, rather than a wholesale condemnation of aleatory transactions, a more subtle and sophisticated approach to risk is called for in the light of recent intellectual advances.[33]

Put differently, rather than avoiding risk, financiers must learn to control it. But the danger of over-reliance on secular experts is that of falling into the trap of 'market fundamentalism'.[34] Economics textbooks usually explain that speculators play a 'positive and necessary' role in the

economy. The benefits of debt and the advantages of using 'OPM' (other people's money) are highly touted. Finance professors have routinely justified egregious behaviour[35] and glorified dubious characters such as 'junk bond king' Michael Milken.[36] There is even an Orwellian tinge to the language of finance. Thus 'hedge funds', whose purpose as suggested by their name is theoretically to mitigate risk, have become instruments of the riskiest form of speculation.[37]

Nor is there a credible consensus among secular experts. To be sure, the dominant economic orthodoxy assumes that a minimally regulated finance is good for the general welfare, and that the financial economy is a reasonably accurate reflection of the underlying real economy.[38] Yet other scholars have noted the disconnection between the financial economy and the real economy. Susan Strange for example has described it as the erratic, volatile world of 'casino capitalism', that bears little resemblance to the textbook universe of finance.[39] The international financial crisis of 1998 has shown that the leading experts of secular finance – Myron Scholes and Robert Merton who won the Nobel Prize in economics in 1997 for their contribution to the pricing of options and yet whose Long-Term Capital Management hedge fund collapsed the following year – can get it wrong.[40]

One could therefore see how, by relying on the rationalizations of certain experts, virtually any financial transaction could be justified. One manifestation of the range of disagreement is the 'fatwa wars', which can only intensify as finance gains in complexity. Financial institutions are likely to step up the competition for scholars ready to justify whatever suit the institutions' preferences.[41]

3.4 The Moral Economy of Islam

Joan Robinson identified the three pre-requisites for an economic system as being 'a set of rules, an ideology to justify them, and a conscience in the individual which makes him strive to carry them out'.[42] The ethical dimension is all too often forgotten, though it exists, as we shall see later, in any society.[43] This section explores the moral economy, or ethical framework, of Islam.

Hard work and participation in economically creative activity is obligatory for every Muslim (62:10).[44] The importance of productivity has been justified as follows:

> Economic activity is not to be confined to earning or producing enough to meet one's personal needs only. Muslims are expected to produce more because they cannot participate in the process of purification through providing security to others (zakat or alms tax) unless they produce more than what they themselves consume. The most recommended use of fairly earned wealth is to apply it to procuring of all means to fulfill a Muslim's covenant with Allah.[45]

The broad ethical/economic system emphasizes fairness and productivity, honesty in trade and fair competition (17:35; 26:181–3),[46] the prohibition of hoarding wealth and worshipping it (104:2–4),[47] and the protection of human beings from their own folly and extravagance. Such a system, although rooted in an ancient tradition, is not, at least in its broad outlines, far removed from many contemporary approaches to ethical business practices.

As for the ethical/economic justification for the prohibition of riba, it is three-pronged: riba is unfair, it is exploitative, and it is unproductive. Under a traditional interest-based relation between borrower and lender, the borrower alone either incurs the losses or reaps disproportionately high benefits. Conversely, the lender makes money irrespective of the outcome of the business venture. Islam prefers that the risk of loss be shared equitably between the two. In other words, rather than collecting a 'fixed, predetermined' compensation in the form of interest, lenders should be entitled to a share from any profits from a venture they have helped to finance. The broader argument is that any profit should be morally and economically justified. Hence the injunctions against aleatory contracts and gharar where gain is the result of chance, or undetermined causes. As in other religions, riba was also seen as exploitative, since it tended to favour the rich, who were guaranteed a return, at the expense of the vulnerable who assumed all the risk.

Significantly, the issue of fairness is not unrelated to issues of productivity and efficiency. Earning a profit is legitimate when one is engaged in an economic venture and thereby contributes to the economy. By certain accounts, Meccan merchants in the days of the Prophet routinely engaged (usually in-between arrivals and departures of caravans) in interest-based lending, speculation and aleatory transactions.[48] This would account for the sharp distinction drawn in the Koran between profit from trade and profit from riba. While the former benefited the community and enhanced welfare, the latter diverted resources towards non-productive uses and contributed to illiquidity and scarcity.[49] The modern-day equivalent of that debate contrasts the real, productive economy with the financial, speculative one. Some Islamic economists have also argued that an interest-based economy was inherently inflationary and caused unemployment and poverty because the creation of money was not linked to productive investment.[50]

3.5 A Historical and Comparative Approach

There are striking similarities between the spirit and often the letter of all Abrahamic religions on economic matters. All three emphasize justice through just wages and just prices, criticize speculation and wasteful consumption, and advocate moral behaviour in commerce. This section considers primarily the attitudes towards interest. While injunctions were

often identical in the pre-capitalist world, changes in the Western world, in particular since the sixteenth century, have led to new intellectual and theological attitudes. After the idea of a moderate, legally capped interest to replace the previous ban on usury gained ground, there was a movement to eliminate such ceilings and let 'the market' determine interest rates.

Moral qualms about money were common in the pre-capitalist world. In ancient Mesopotamia, the Hamurabi code (1800 BC) placed limits on interest rates and banned compound interest (interest on the interest). Aristotle provided the most influential argument about the 'barrenness' of money: it should be a means of exchange and should not be allowed to multiply. The Romans allowed interest but regulated interest rates.[51]

The scholastic tradition among Christian theologians made the Aristotelian case that money was a 'sterile commodity'. The long-standing rule was *pecunia pecuniam non parit*, or money does not make money. The canon (which was not necessarily shared by the classical scholars of Islam) also considered the 'pricing of time' illegitimate, since 'time belongs to God'. Unlike the farmer or the craftsman who actually produced something, money-lenders did not.[52]

Judaism, Christianity and Islam considered that the lender, by definition, possessed a store of capital that exceeded his requirements, while the borrower lacked the resources to satisfy his immediate needs. It would thus be unfair and even immoral for a needy borrower both to repay the capital and to increase the lender's wealth still further by paying him interest, especially since the additional amount must be taken from the fruit of the borrower's industry. All three religions preached that the prosperous had a duty to assist the needy, if not by gifts, at least through interest-free loans.[53]

Importantly however, if those religions were very similar, they were not identical. The Jewish tradition generally prohibited interest (Leviticus 25:36).[54] A loophole however allowed interest for money lent to non-Jews (Deuteronomy 19:19-20).[55]

The Christian gospels do not mention interest specifically, though they repeatedly denigrate moneymaking and economic pursuits.[56] As is the case with Judaism and Islam, the Christian tradition recommends that lenders forgive parts of their loans to the poor (Luke 6:34–5).[57] Later Christian tradition provided for something called 'antidora', a spontaneous and unforced gift of the borrower to the lender to thank him for his loan. Unlike conventional interest, it was not obligatory, pre-determined and fixed, but voluntary and in an amount left to the discretion of the borrower.[58]

In Christianity as in Islam, there is also the principle of purification of ill-gotten gains. It was common in the Christian Middle Ages for money-lenders to lighten their guilt 'by including in their will a token bequest to a charity and calling it restitution of any "ill-gotten" money'.[59] Money lenders were sinners, but they were not beyond salvation: 'Indispensable but

malodorous, they were deliberate public sinners, likened to prostitutes, and hence tolerated on earth but earmarked for hell unless they repented, and made full restitution of their accursed gains'.[60] Historian Jacques Le Goff draws interesting connections between the invention of the concept of purgatory in the second half of the twelfth century, and money-lending. In his words, 'the birth of purgatory is also the dawn of banking'.[61]

Economic transformations created new financial needs and typically resulted in an intensification of the debates over usury.[62] 'The more frequent practices contrary to doctrine become', wrote Maxime Rodinson,

> the more the ideological authorities (if they want to retain, on the one hand, some influence over society, and, on the other, some degree of coherence in their intellectual system) are led to theorize with finesse and subtlety, to allow for cases, exceptions, degrees of guilt and of innocence, means of atoning more or less fully for one's offences, and to work out a graduated scale of penalties and tolerances. It therefore seems quite in order that, in mediaeval Christian society as in Muslim society, it was at the very moment when capitalistic practices implying the need for interest were developing with the greatest vigor that the theologians and religious lawyers took the greatest trouble to theorize about the prohibition of interest, justifying it, explaining it and allowing for cases and exceptions.[63]

Similarly, Abraham Udovitch noted: 'The frequent, copious, and vehement reiteration of the prohibition against usury in medieval Islamic religious writings has been interpreted by some scholars as indirect testimony to its equally frequent violation in practice'.[64]

In medieval Europe, the ban on usury had been repeatedly reaffirmed. The Council of Reims (1069) and the Second Lateran Council (1139) condemned usury. The Third Lateran Council (1179) excommunicated usurers, and the Fourth Lateran Council (1215) permitted Jews to practise it. The Council of Lyon (1274) reiterated the condemnation and marked the first official recognition of salvation by purgatory. The arguments of the scholastics and other canonists remained virtually unchallenged throughout the thirteenth and fourteenth centuries. Like the Third Council of Lateran, the Second Council of Lyons in 1274 proclaimed that Christians who received interest would be excommunicated.[65] In 1311 the Council of Vienna declared that secular legislation that did not prohibit interest was invalid, and that anyone who asserted otherwise was a heretic who would be punished accordingly. In the fifteenth and sixteenth centuries, increasing attention was devoted to the question of the licitness of new financial institutions and practices.[66]

It was only in 1515 that the Church, at the Lateran Council, legitimated interest on secured loans. Although it still took a long time before the idea was fully accepted, new and increasingly subtle approaches to money-

lending (often inspired by the Islamic hiyal) had been gaining ground. There were a number of ways of circumventing prohibitions on usury, which in its canon law definition meant 'whatever is added to the principal'.[67] One was the traditional 'free and loving loan' (*mutuum gratis et amore*), a loan with a built-in, concealed interest.[68] Perhaps the most significant invention in that respect was the 'letter of exchange'.[69] As a first step, the idea of a small interest for certain purposes was accepted. The Jesuits for example approved of commercial credit.[70]

A counter-theory of usury appeared with the Protestant Reformation. The reformers, no longer bound by canon law, engaged in significant innovation on matters of political economy and money. Martin Luther (1483–1546) urged Christians to participate fully in the world and challenge Church teachings. John Calvin (1509–64) argued that religious fulfilment came from hard work and not merely from prayer and spiritual contemplation. In his famous 'Letter on Usury' (1545), Calvin stated that usury is licit, but 'not everywhere, nor always, nor in all goods, nor from all'. He used the golden rule as a guide: usury is sinful only if it hurts one's neighbour, and charity and natural equity alone can decide in what particular cases a charge for a loan does hurt a neighbour since each believer is guided by his own conscience. For example, lending to the poor in order to achieve a profit is wicked, but in lending to the rich, a modest profit is acceptable. The ministers of the gospel could lend to merchants, but in such a way that their profit was not certain.[71]

The Calvinist bankers in Geneva were thus free to develop their financial interests without any feelings of guilt, provided they observed the Christian teaching on justice to the poor, and that they were totally honest in their dealings.[72] In time, some of Calvin's followers sought to eliminate some of the 'exceptions' that Calvin had provided for. In 1630 Calvinist classicist Claude Saumaise (1588–1653) took the defence of usurers who lent to the poor. In his view, the money-lender performs a highly useful service, as does anyone who provides a means for meeting a great public need. His views, as summarized by John Noonan, are:

> If it is licit to make money with things bought with money, why is it not licit to make money from money? Everyone makes his living from someone else; why should not the usurer? The seller of bread is not required to ask if he sells it to a poor man or a rich man. Why should the moneylender have to make a distinction?

Saumaise also defended high interest charges, which he saw as beneficial in stimulating the borrowers to repay more quickly. In his view, it is negligence, inertia and prodigality that are the real enemies of the poor, not the usurer.[73]

Such views become common, especially in England, with the advent of industrialization and the triumph of the capitalist ideology. In letters written in 1787 'in defence of usury', Jeremy Bentham made the case for the

'the liberty of making one's own terms in money bargains'.[74] He noted the mischief of anti-usurious laws, principally 'that of precluding so many people, altogether, from the getting the money they stand in need of, to answer their respective exigencies', and 'the distress it would produce, were the liberty of borrowing denied to every body'.[75] Bentham objected in particular to the differentiation made between money-lending and other forms of commerce:

> Why a man who takes as much as he can get, be it six, or seven, or eight, or ten per cent for the use of a sum of money, should be called usurer, should be loaded with an opprobrious name, any more than if he had bought an house with it, and made a proportionable profit by the house, is more than I can see.[76]

In sum, the history of ideas in relation to money had gone through three stages. In the first one, usury was generally forbidden. In the second one, a small rate of interest, regulated by the state, was permitted. In the theological debate, a new emphasis was placed on those passages of the gospels that stressed the need for wealth to fructify. Thus the parable of the talents stresses the need to be productive (Matthew, 25:14–30). In another parable, a nobleman calls 10 of his servants before a long journey, giving them a pound each saying, 'Trade with this while I'm away.' Upon his return, the servants who used the funds their master had provided to make additional money were praised, whereas the servant who merely returned the money without gain was condemned (Luke, 19:22–6).

Catholic countries were somewhat slower in formally endorsing this view. Thus in France, interest-based loans were only formally legalized in October 1789 (and later incorporated in the Napoleonic civil code).[77] The Egyptian code (as well as other codes in the Islamic world that were influenced by it), inspired by the French code, also adopted the view that interest was legal provided it was limited by law. In the third stage, the prevailing view was that existing ceilings were too low and that they should either be significantly increased or removed altogether. In line with the free-market ideology, it was argued that it was up to the market to determine interest rates. Nowadays, and especially with the deregulation movement of the 1980s, while most countries still have laws on the books against usurious rates and against extortionary lending, it is a Benthamite logic that prevails, as usury ceilings have been allowed to rise significantly or to be overridden under most circumstances.

Despite this evolution, misgivings about finance and about the 'unearned' quality of financial profits have not subsided. There is a considerable literature on predatory and unproductive finance, ranging from critiques of rentier economies and parasitic groups, to the pernicious effects of debt, to scathing portraits of the misdeeds of financiers.[78] In the United States, despite the dominance of the free-market ideology, there is

a long history of suspicion of banks and financiers. At the time of the controversy over the chartering of the Bank of the United States, Thomas Jefferson had argued that it was only 'the speculators, the creditors, and the wealthy bank stockholders who benefited from a public debt' and that 'the bankers had no stake in general prosperity or public well-being except insofar as they generated tax revenues to pay the interest charges that enriched them'.[79] At times of economic hardship – for example in the 1890s and 1930s – bankers and financiers were the designated culprits.[80] During the Great Depression, bank robbers became folk heroes. In recent years 'paper entrepreneurs' were attacked for shuffling assets without creating value,[81] just as 'Wall Street' (in the 1990s, announcements of layoffs would invariably boost a company's stock) was criticized for having interests that were antithetical to those of 'Main Street'.[82]

Notes

1. Anwar Iqbal Qureshi, *Islam and the Theory of Interest*, Lahore: Ashraf 1974, p. 4.
2. Ziaul Haque, *RIBA: The Moral Economy of Usury, Interest, and Profit*, Selangor, Malaysia: Ikraq 1995.
3. Edward Mortimer, *Faith and Power: The Politics of Islam*, New York: Random House 1982, p. 245.
4. Fazlur Rahman, 'Riba and Interest', *Islamic Studies: Journal of the Ccntral Institute of Islamic Research*, Karachi, Vol. 3, No. 1. 1964, p. 42.
5. See Baldwin and Wilson, 'Islamic Finance in Principle and Practice, with special reference to Turkey', in Chibli Mallat (ed.), *Islamic Law and Finance*, London: Graham and Trotman 1988.
6. Hence the Koranic verse 3:129 'O you who believe, devour not riba, doubling and redoubling and keep your duty to Allah, that you may be successful.'
7. The Hadith, in its abbreviated form: The Prophet said: '[Exchange] gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, measure for measure and hand-to-hand. If the [exchanged] articles belong to different genera, the exchange is without restraint provided it takes place in a hand-to-hand transaction.' Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, gharar and Islamic banking*, Cambridge University Press 1986.
8. William E. Shepard, 'Muhammad Sa'id Al-Ashmawi and the Application of the Shari'a in Egypt', *International Journal of Middle East Studies* 28 (1996), p. 46.
9. Chibli Mallat, *The renewal of Islamic law: Muhammad Baqer as-Sadr, Najaf and the Shi'i International*, Cambridge University Press 1993, pp. 162–84.
10. Chibli Mallat, 'The debate on riba and interest in twentieth century Egypt', in Chibli Mallat (ed.), *Islamic Law and Finance*, London: Graham and Trotman 1988, pp. 69–88.
11. Ibid.
12. Fuad Al-Omar and Mohammed Abdel-Had, *Islamic Banking: Theory, Practice and Challenges*, London: Zed Books 1996, p. 8.
13. See Chapter 4.
14. Chibli Mallat, 'Tantawi on banking', in Muhammad Khalid Masud, Brinkley Messick and David S. Powers (eds), *Islamic Legal Interpretation: Muftis and their Fatwas*, Harvard University Press 1996, pp.286–96.
15. Ibid.

16. Reuters, 30 May 1995.
17. Agence France-Presse, 22 August 1997.
18. Koran 2:275 'Those who swallow riba cannot rise except as he arises whom the devil prostrates by [his] touch. This is because they say, Trading is only like riba. And Allah has allowed trading and forbidden riba. To whomsoever then the admonition has come from his Lord, and he desists, he shall have what has already passed. And his affair is in the hands of Allah. And whoever returns [to it] – these are the companions of the Fire: therein they will abide'.

    2:276 'Allah will blot out riba, and He causes charity to prosper. And Allah loves not any ungrateful sinner'.

    2:277 'Those who believe and do good deeds and keep up prayer and pay the poor-rate – their reward is with their Lord; and they have no fear, nor shall they grieve'.

    2:278 'O you who believe, keep your duty to Allah and relinquish what remains [due] from riba, if you are believers'.

    2:279 'But if you do [it] not, then be apprised of war from Allah and His Messenger; and if you repent, then you shall have your capital. Wrong not, and you shall not be wronged'.

    2:280 'And if [the debtor] is in straitness, let there be postponement till [he is in] ease. And that you remit [it] as alms is better for you, if you only knew'.

    2:281 'And guard yourselves against a day in which you will be returned to Allah. Then every soul will be paid in full what it has earned, and they will not be wronged'.

    3:129–30 'O you who believe, devour not riba, doubling and redoubling and keep your duty to Allah, that you may be successful. And guard yourselves against the fire which has been prepared for the disbelievers'.

    4:161 'And for their taking riba – though indeed they were forbidden it – and their devouring the property of people falsely. And We have prepared for the disbelievers from among them a painful chastisement'.

    30:39 'And whatever you lay out at riba, so that it may increase in the property of men, it increases not with Allah; and whatever you give in charity, desiring Allah's pleasure – these will get manifold'.
19. Philip Hitti, *Islam: A Way of Life*, Oxford University Press 1970, p. 23.
20. Al-Omar and Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges*, London: Zed Books 1996, p. 9.
21. Among the notable exceptions are Nabil Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law*, Cambridge University Press 1986 (a second edition was published by Kluwer Law International in 1992); and Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk and Return*, The Hague: Kluwer Law International 1998.
22. Koran 31:33 'Let not this world's life deceive you, nor let the great deceiver (the devil) deceive you about Allah'.
23. Saleh, p. 53.
24. Maxime Rodinson, *Islam and Capitalism*, London: Penguin 1978, p. 16.
25. A game of chance played by Arabs. The derivation is either from yusr (facility or ease, i.e., ease with which wealth could be attained) or from yasara (dividing anything into parts or portions).
26. Koran 2:219 'They ask thee about intoxicants and game of chance. Say: In both of them is a great sin and [some] advantage for men, and their sin is greater than their advantage. And they ask thee as to what they should spend. Say: What you can spare. Thus does Allah make clear to you the messages that you may ponder'.

    5:90 'O you who believe, intoxicants and games of chance and [sacrificing to]

stones set up and [dividing by] arrows are only an uncleanliness, the devil's work; so shun it that you may succeed'.

5:91 'The devil desires only to create enmity and hatred among you by means of intoxicants and games of chance, and to keep you back from remembrance of Allah and from prayer. Will you then keep back?'

27. Vogel and Hayes, pp. 87–8.
28. Vogel and Hayes, pp. 89–90.
29. Mallat, 'Tantawi on banking', pp. 286–96.
30. Ibid.
31. Ibid.
32. Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk*, New York: Wiley 1997.
33. See Chapter 2.
34. See Chapter 2.
35. Benjamin J. Stein, *License to Steal: The Untold Story of Michael Milken and the Conspiracy to Bilk the Nation*, New York: Simon and Schuster 1992.
36. Ibrahim Warde, 'Michael Milken, ange et martyr', *Le Monde diplomatique*, August 1993.
37. Ibrahim Warde, 'La grande kermesse de l'économie financière', *Le Monde diplomatique*, June 1993.
38. Ibrahim Warde, 'La tyrannie de l'économiquement correct', *Le Monde diplomatique*, May 1995.
39. Susan Strange, *Casino Capitalism*, Oxford: Basil Blackwell 1986.
40. Ibrahim Warde, 'Le système bancaire dans la tourmente' and 'LTCM, un fonds au-dessus de tout soupçon', *Le Monde diplomatique*, November 1998.
41. Michel Gallois, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*, Paris: Presses universitaires de France 1997.
42. Joan Robinson, *Economic Philosophy*, London: C. A. Watts 1962, p. 13.
43. James C. Scott, *The Moral Economy of the Peasant: Rebellion and Subsistence in Southeast Asia*, Yale University Press 1976.
44. Koran 62:10 'But when the prayer is ended, disperse abroad in the land and seek Allah's grace, and remember Allah much, so that you may be successful'.
45. Khalid M. Ishaque, 'The Islamic Approach to Economic Development', in John L. Esposito, *Voices of Resurgent Islam*, Oxford University Press 1983, p. 271.
46. Koran 17:35 'And give full measure when you measure out, and weigh with a true balance. This is fair and better in the end'.

    26:181–3 'Give full measure and be not of those who diminish. And weigh with a true balance. And wrong not men of their dues, and act not corruptly on earth making mischief'.
47. Koran 104:2–4: 'Woe to who amasses wealth and counts it. He thinks that his wealth will make him abide. Nay, he will certainly be hurled into the crushing disaster'.
48. Henry Lammens, *La Mecque à la veille de l'Hégire*, Beirut: Imprimerie catholique 1924.
49. Traute Wohlers-Scharf, *Arab and Islamic Banks: New Business Partners for Developing Countries*, Paris: OECD 1983, p. 75.
50. Ahmed Abdel Aziz El-Nagar, *One Hundred Questions & One Hundred Answers Concerning Islamic Banks*, Cairo: International Association of Islamic Banks 1980, p. 8.
51. Hamid Algabid, *Les banques islamiques*, Paris: Economica 1990, pp. 48–50.
52. John Noonan, *The Scholastic Analysis of Usury*, Harvard University Press 1957.
53. J. Pierre V. Benoit, *United States Interest Rates and the Interest Rate Dilemma for the Developing World*, Quorum Books 1986, pp. 34–55.

54. Leviticus 25:36 'You shall not charge your brother interest on a loan, either by deducting it in advance from the capital sum, or by adding it on repayment'.
55. Deuteronomy 19:19 'Do not charge your brother interest, whether on money or food or anything else that may earn interest'.
    19:20 'You may charge a foreigner interest, but not a brother Israelite, so that the Lord your God may bless you in everything you put your hand to in the land you are entering to possess'.
56. Luke 16:13 'No servant can be the slave of two masters; for either he will hate the first and love the second, or he will be devoted to the first and think nothing of the second. You cannot serve both God and Money'.
    Luke 18:22 'Sell everything you have and distribute to the poor, and you will have riches in heaven'.
    Luke 18:24–5 'How hard it is for the wealthy to enter the kingdom of God! It is easier for a camel to go through the eye of a needle than for a rich man to enter the kingdom of God'.
57. Luke 6:34–5 'And if you lend only where you expect to be repaid, what credit is that to you? Even sinners lend to each other to be repaid in full. But you must love your enemies and do good; and lend without expecting any return; and you will have a rich reward'.
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4

THE EVOLUTION OF MODERN ISLAMIC FINANCE

Following a few pioneering experiments, modern Islamic finance started in earnest in the 1970s. Largely driven by the oil boom, it was bound to be transformed by the collapse of oil prices in the 1980s, and more generally by changes in the global political and economic system. Many of the assumptions underlying the aggiornamento of the 1970s became somewhat obsolete, and a new aggiornamento has since been taking shape. This chapter traces the evolution of modern Islamic banking and finance. The following chapter will delve in greater detail into the connection between these developments and broader political and economic changes.

4.1 Precursors

A few pilot experiences preceded the formal start of Islamic banking. In the Indian subcontinent, loan cooperatives, influenced by European mutual loan experiments[1] and infused with religious and ethical ideals, were started from the 1940s.[2] At least one (short-lived) experiment took place in Pakistan in the late 1950s, when rural landlords created an interest-free credit network.[3] In Malaysia, the Muslim Pilgrims Savings Corporation was set up in 1963 to help people save for performing their religious pilgrimage (haj). It later evolved into the Pilgrims Management and Fund Board, or the Tabung Haji as it is now popularly known – an Islamic savings bank of sorts which invested the savings of prospective pilgrims in accordance with the Shariah.[4]

The highest profile experiment was conducted in Egypt between 1963 and 1967, in Mit Ghamr in the Nile Delta. The founder, Dr Ahmed al-Najjar (who would later become Secretary of the IAIB [International Association of Islamic Banks]), had been educated in West Germany and greatly influenced by the mutual savings schemes he discovered there. With capital supplied by West German banks, he obtained the support of the Egyptian government. At its peak, the bank had nine branches in operation, 250,000 depositors and close to two million Egyptian pounds in deposits. Although its charter made no reference to Islam or the Shariah, the bank neither paid nor charged interest. It earned profits by engaging in trade and

industry directly or in partnership with others, and to a lesser extent by financing business on a profit-sharing basis.[5] The circumstances of its closure are somewhat obscure. By certain accounts the bank had encountered severe financial problems. Others suggest that the bank was commercially successful but was closed for political reasons, which ranged from fear of Islamic fundamentalism to disagreements over how the bank should be regulated.[6]

In 1971, as part of its policy of coopting Islamic groups in its fight against leftist elements, the Egyptian government created the Nasser Social Bank. The official goals were to 'broaden the base of social solidarity among citizens' and 'provide aid to needy citizens'. As with the previous experiment, there was no direct reference to religion, but the bank's operations were based on mudaraba (profit-and-loss sharing) and the collection and distribution of zakat (almsgiving).[7]

Finally, a few experiments involving Islamic money management took place around the same period. In Egypt, Abd Al-Latif Al-Sharif, who at one time had to flee to Saudi Arabia to avoid Nasser's persecution of the Muslim Brothers, founded the Al-Sharif company in the sixties.[8] The company would gain notoriety in the 1980s as one of the leading Islamic Money Management institutions.

4.2 The First Aggiornamento

Since the late 1940s, theoretical works, written mostly by Pakistani scholars, had addressed the feasibility of a financial system that would conform with the Shariah. But it took a number of political and economic developments, more specifically the advent of pan-Islamism and the rise in oil prices, before such ideas were put in practice.[9] The aggiornamento of Islamic doctrine on banking matters occurred under the auspices of the Organization of the Islamic Conference (OIC), then largely dominated by Saudi Arabia. Most accounts suggest that the turning point occurred when, in the early seventies, King Faisal of Saudi Arabia was sold on the idea of the creation of a pan-Islamic bank. These were heady days for oil-producing countries, many of which having already moved to take control over their economic destiny by progressively nationalizing the 'commanding heights' of their economies, including oil industries and financial institutions.[10] The quadrupling of oil prices in 1973–4 marked a watershed, leading many to believe it had ushered in if not a New International Economic Order (NIEO), at the very least a new era in North–South relations.[11] Under those circumstances, an Islamic banking system held the promise of more control over the Islamic world's political and economic destiny. It was also assumed that idle funds that had stayed away from the conventional (or interest-based) banking system would flock to a system devised according to Islamic precepts.

As the issue moved to the forefront of the Islamic agenda, the challenge was to devise a system that would be at once consistent with religious precepts and viable in a modern economy. Hence an unprecedented 'ijtihad' that built on earlier attempts to redefine financial concepts and practices. At the Third Islamic Conference, held in Jeddah in 1972,[12] a comprehensive plan to reform the monetary and financial systems according to Islamic ethics was presented to the foreign ministers of participating countries.

The 1974 OIC summit in Lahore voted to create the inter-governmental Islamic Development Bank (IDB), which was to become the cornerstone of the Islamic banking system. In addition to injecting funds into the regions where they were most needed and providing fee-based financial services and profit-sharing financial assistance to member countries – in the spirit of the NIEO and of Southern solidarity – the new institution was to promote, through direct participation, training and advice, the creation of additional Islamic institutions. It would also manage the income from interest received from non-Muslim countries, as well as from zakat funds, finance reciprocal trade and serve as a clearing house for international payments between Muslim countries. Forty-four countries were founding members of the bank, the largest shareholders being Saudi Arabia (25%), Libya (16%), the United Arab Emirates (14%) and Kuwait (13%).

The Dubai Islamic Bank, created in 1975, is considered to be the first modern, non-governmental, Islamic bank. Before the decade was over, similar banks sprouted throughout the Islamic world: the Kuwait Finance House (1977), the Faisal Islamic Bank of Egypt (1977), the Islamic Bank of Sudan (1977), the Jordan Islamic Bank for Finance and Investment (1978), the Bahrain Islamic Bank (1978), and the International Islamic Bank for Investment and Development in Egypt (1980). In addition, a handful of international investment banks were created, such as the Islamic Investment Company in Nassau (1977), the Islamic Investment Company of the Gulf in Sharjah (1978), the Shariah Investment Services in Geneva (1980) and the Bahrain Islamic Investment Bank in Manama (1980).[13] Those developments would not have been possible without the influence of a handful of pioneers, chief among them Prince Mohammed al-Faisal al-Saud (a son of King Faisal), whose role as entrepreneur, lobbyist and proselytizer will be further discussed in the following pages. Another early pioneer was Sheikh Saleh Kamel, a self-made Saudi businessman and founder of the Dallah Al-Baraka group. According to Clement M. Henry, 'Each was a determined and principled innovator, noted for his piety as well as his entrepreneurship.'[14]

The paradigm of modern Islamic banking was established in those years. Since riba was defined as interest, Islamic banking became synonymous with interest-free banking. The prevailing belief was that interest-based banking would be primarily replaced by profit-and-loss sharing (PLS)

schemes. Many questions however were left unresolved, for example whether banks could invest in bonds or debentures, earn interest on their balances with conventional banks, or be involved in commodity trading and similar operations that could involve uncertainty or speculation. Nor was the question of the dealings between Islamic and non-Islamic institutions fully addressed. Yet the oil bonanza as well as the novelty of the concept allowed considerable latitude for experimentation. Funds were plentiful for the handful of Islamic institutions which were in a position to share a monopoly on the small but growing niche of clients looking for Islamically correct investments. Many depositors did not seek any remuneration, thus providing banks with the cheapest possible funding.

Despite the early enthusiasm, the initial evolution of Islamic finance led to disappointment in many quarters. Banks concentrated on trading, leasing and a variety of mark-up schemes. Profit-and-loss sharing arrangements – which were to be the main financial instruments – proved far more complicated to put together. They also did not generate great enthusiasm among depositors, who were fearful of losing their savings.[15] Nor did most banks make the extra effort necessary to expand and promote such products, preferring instead to concentrate on those mirroring conventional products. Perhaps the most common criticism was that interest-free banking was really an exercise in semantics. To many critics, Islamic banks were in reality quite similar to conventional banks since something resembling interest, albeit under a different name, was in the end paid to most depositors and charged to most borrowers. It should be remembered that the seventies were a decade of high inflation worldwide.

In their own defence, Islamic financiers argued that the system was still in its infancy. Governments, and most significantly private-sector pioneers, invested a lot of effort and money to help fine-tune Islamic banking concepts and practices. The creation in 1977 of the International Association of Islamic Banks (presided by Prince Mohammed) provided an additional coordination and advice mechanism for the new banks. Among the IAIB's first initiatives was the publication of the *Handbook of Islamic Banking*.[16] Written in Arabic by leading Islamic scholars, and financed by the Prince, this 'scientific and practical encyclopedia for Islamic bankers' was designed to become the definitive reference for Islamic institutions.

Conceptual and practical issues were to be further clarified under the auspices of the IAIB and other pan-Islamic organizations. At the meeting of the Governors of Central Banks and Monetary Authorities of the Islamic Conference held in Riyad in 1980, Prince Mohammed presented a progress report on Islamic banking. On the same occasion the Islamic Investment Company submitted proposals for Model Islamic Banks and a Model Law for the Establishment, Organization, Regulation and Control of Islamic Banks. Countries were invited to adapt such guidelines to their individual requirements.[17]

The period saw the proliferation of research institutes dedicated to Islamic economics and finance.[18] One example was the Saleh Kamel Center for Islamic Commercial Research created in 1979 at the Al-Azhar University. Funded by the founder of the Dallah Al-Baraka group, its goals were:

> [T]o favor comparative research on Islamic and Western thought in economics, management, and accounting; advise Islamic financial institutions; organize training sessions for their executives, as well as conferences and symposia; publish the Review of Islamic commercial studies; and revive the cultural heritage of Islam, through the translation and publication of ancient works.[19]

In 1979, Pakistan became the first country to embark on a full Islamicization of its banking sector.[20] The following years saw a number of important developments. One was the rapid expansion of transnational networks. The most significant one was the 'Prince Mohammed group', comprised of Islamic banks and investment companies promoted by the Saudi prince. The group included national Islamic banks which provided finance to the general public at local level as well as internationally oriented Islamic investment and holding companies. In addition to the Islamic Investment Company in the Bahamas (with its wholly owned subsidiaries, the Islamic Investment Company of the Gulf and a service company, the Sharia Investment Services company in Geneva), Prince Mohammed set up in 1981 the most ambitious Islamic project ever, Dar Al-Maal Al-Islami (the DMI Group), with a targeted capitalization of $1 billion.[21]

DMI was a potent mix of finance, politics and religion. The founding members – a who's who of Islamic political and religious leaders – signed the 'appeal of the Islamic Umma'. Shareholders belonged to 16 countries: seven countries were represented by their rulers; the others by prominent business, political and religious leaders. The list included 10 Saudi princes, two Kuwaiti princes, the Emir of Bahrain, the Emir of Abu Dhabi (and leader of the United Arab Emirates) Sheikh Zayed Bin Sultan al-Nahyan, Guinean President Ahmed Sekou Toure, Pakistani leader Zia ul-Haq and even the exiled King Fuad II of Egypt (who signed the manifesto from his residence in Monaco). The Sudanese signatories were the President Jaafar al-Nimeiri, the Prime Minister Sadeq al-Mahdi, and Hassan al-Turabi, president of the National Islamic Front. Egyptian signatories included, in addition to the former king, Ibrahim Kamel, a pioneer of Islamic banking, and Omar Abdul-Rahman.[22] DMI was registered as a trust under the laws of the Bahamas and managed by an 18-member board. Its wholly owned operating company, DMI S.A. was registered in Geneva. A six-member Religious Supervision Board was to ensure that operations were conducted in accordance with the Shariah.

The very name of the group evokes the golden age of Islam, since Dar Al-Maal Al-Islami was the organization in charge of public finance and

almsgiving. As for being headquartered in non-Islamic tax and regulatory havens, the internal information bulletin of the group explained that it was 'for reasons of neutrality and political security'. The bulletin added that 'given the Islamic nature of the enterprise and the desire to promote unity inside the Islamic umma', the founders hoped that 'in the nearest possible future, a company would be created within the legal framework of an Islamic state, whose headquarters would be in Mecca, thus emphasizing its pan-Islamic character.' The statement also said that 'this transformation should not affect the economic interests of the DMI shareholders'.[23]

From the outset, DMI had ambitious expansion plans: financing development and setting up a worldwide network of subsidiary Islamic banks, investment and insurance companies in the 'Umma West' (Africa), the 'Umma Center' (the Persian Gulf, North Africa and Turkey), the 'Umma East' (Pakistan, Bangladesh, Malaysia) and even outside the Islamic world, in the Americas, Europe and the Far East.[24] With such political and financial firepower, backed up by religious credentials, the group was in a position to enter most markets it targeted, often on favourable terms.

The early eighties also saw further 'full Islamicizations' of banking systems (the Sudan and Iran in 1983). Another interesting development was the decision by Danish authorities to authorize the creation of the Islamic Bank International, which would operate according to the Islamic Shariah without any special concessions or exceptions granted. This marked a breakthrough insofar as it showed the compatibility of Islamic banks with conventional banking frameworks, including in countries with small Islamic populations and tenuous relations with the Islamic world.

4.3 The Changing Context of Islamic Finance

The first aggiornamento was associated with the politics and economics of the 1970s – primarily the oil boom and the rise of pan-Islamism. In the words of Kiren Aziz Chaudhry, 'The capital flows of the 1970s reshaped the domestic institutions and economies of each constituent country: whole classes rose, fell, or migrated; finance, property rights, law, and economy were changed beyond recognition'.[25] In the Middle East, a new regional economy took shape, characterized by a sharp increase in trade, aid, labour migration and capital movements. Modern Islamic banking had been a creature of that era. But the price of oil peaked in 1981 and after a steady decrease, collapsed in 1986. The political and economic context of the mid-eighties was thus quite different from that of the previous decade, and it challenged many of the assumptions of the first aggiornamento.

At the same time, other factors gave Islamic finance a second wind. In November 1985, the Islamic Fiqh Academy, meeting in Jeddah, made an appeal to all Islamic countries to facilitate the creation of Islamic banks. It also decided to forbid Muslims from using a conventional bank if an Islamic

bank was available in their area.[26] Needless to say, neither injunction had immediate results. At the very least however, it marked a further commitment by the Islamic community to the cause of Islamic finance, and made outright governmental opposition to Islamic finance difficult.

The collapse of oil prices caused sharp decreases in the revenues of oil-rich states, with attendant economic, political, social and religious consequences throughout the Islamic world: cancellation of contracts, reduction of subsidies and public expenditures, drop in foreign workers' remittances, political and social unrest, and growing Islamic militancy. Other major political economic and financial changes were taking place in the world at large – the winding down of the cold war, the spread of neo-liberal ideology and deregulation and privatization policies, and the transformation of finance[27] – which in due course profoundly affected the Islamic world.

These developments did not hinder the growth of Islamic financial institutions. In fact, countries that experienced financial difficulties welcomed the major Islamic groups. In Turkey for example, the creation of the 'Special Finance Houses' (Islamic banks) occurred in 1983 under a temporary military dictatorship which paradoxically 'supported secularism with a zeal reminiscent of Muslim "fundamentalism"'.[28] But since the country was in the midst of a financial crisis, its secular leaders courted Islamic banking groups, granting them unprecedented privileges. In those years, Turkey also obtained substantial aid from other Arab and Islamic sources, particularly the Islamic Development Bank (IDB). The decree that established the Special Finance Houses gave them rights and privileges that were not available to their conventional competitors. It reserved to the Prime Ministry the right 'at all times' to supervise them. After the Al-Baraka and Faisal groups opened their banks, a special law specifically exempted them from the provisions of the existing banking legislation. The new institutions were required to keep as reserves with the Central Bank only 10 per cent of their current accounts and a mere one per cent of their much larger participation accounts (in contrast to the 10 to 15 per cent reserve requirement to which conventional banks were subjected). The 'Special Finance Houses' were also authorized to deal in commodities and were exempted from the lending limits and deposit insurance requirements to which other commercial banks were subjected. And despite a 1984 ban on television advertising for banks (in the wake of the brokerage houses crisis) they were given permission to advertise on state television. According to a Turkish journalist, all these privileges amounted to a new 'form of capitulation'.[29]

In sum, because of the financial crunch experienced by governments, the bargaining power of Islamic bankers grew and they were able to keep on expanding. Yet with the dramatic economic transformations, many of the assumptions, indeed the founding principles, underlying the 'ijtihad'

of the first aggiornamento crumbled. In particular, the world of international finance, which had not changed much in the fifties, sixties and seventies, underwent a veritable revolution in the eighties, and one that has accelerated since.[30] The *Handbook of Islamic Banking* thus left out a wide range of financing techniques and instruments, and adopted what in hindsight appears as an unduly restrictive position on many products that later gained great currency. For example, the *Handbook* stated that transactions involving financial derivatives such as futures and options were forbidden,[31] as were purchases of government bonds and fixed-return securities.[32] Also, Islamic banks could not purchase stocks or commodities for short periods of time solely to make a profit. (Such transactions also had to be aimed at promoting investment.[33])

A new aggiornamento was therefore needed to deal with the changing position of Islamic finance within the international political economy and the new world of finance. Islamic finance grew more decentralized, diverse and pragmatic. As the following section shows, new forms of Islamic finance came into existence outside of the networks created by the first aggiornamento.

4.4 New Forms of Islamic Finance

In the 1980s, the pioneers of the aggiornamento lost their near-monopoly on Islamic finance. Egypt, for example, saw the proliferation of *sharikat tawzif al-amwal al-islamiyya* or 'Islamic Money Management Companies' (IMMCs). With the exception of the Al-Sharif group mentioned earlier, these companies appeared in the early 1980s. Unrelated to existing Islamic banks, they came to dominate Egyptian finance, and even the country's economics and politics throughout the 1985–8 period.[34]

The emergence of IMMCs was the result of a combination of factors: the loopholes in the infitah (open-door) policies, the growth of labour remittances, the rigidities of the banking system, the drop in government revenues, and of course the rise of Islamism. The policy of infitah, inaugurated in the early 1970s by Anwar Sadat and pursued under the Mubarak regime, had introduced significant changes, but it did not do away with some of the essential characteristics of pre-infitah policies. '*Infitah* has often been misrepresented,' wrote Yahya Sadowski,

> by its advocates and its opponents, as marking a change from a state-directed to a free-market economy in Egypt. It unquestionably led to important changes in economic structure, but fostered only limited liberalization. It legalized a wide range of imports, but kept tariff barriers high. It promoted private banking, but kept interest rate regulations intact. It left most price controls in place and expanded consumer subsidies. It created a more liberal economy, but one whose basic features were still clearly *dirigiste*.[35]

The integration of Egypt within the regional economy (in addition to the massive aid received from the United States following the Camp David Agreements) transformed Egypt's financial situation. Migrant workers, who needed to repatriate their hard currency, found few outlets for their savings. Credit and interest rates were tightly regulated, and cumbersome and outdated rules and regulations still prevailed. As a result, interest rates offered by banks did not even compensate for inflation, and most of the available credit went to finance short-term trading, established businesses or collateralized transactions. Clearly, the official banking system was unable to cope with the demands of the new economy.

A parallel financial sector was quick to emerge. It started with the black market for foreign exchange. Currency traders suddenly became among the richest businessmen in the country. The government tolerated this black market, 'viewing it as a safety valve that lubricated the wheels of trade and encouraged the flow of dollars into Egypt'.[36] As foreign exchange restrictions were partially lifted, many such dealers evolved into full-service financial institutions. Rather than offering traditional savings accounts, they purported to manage the public's money. And rather than offering traditional loans, they engaged in profit-and-loss sharing arrangements, as well as a variety of mark-up schemes. To their depositors, they issued 'investment certificates'.[37] Since 'dividends' paid under musharaka, mudaraba or murabaha were not technically interest, they were not subject to the government regulations controlling interest rates. And since these companies were not really banks, they were not subjected to costly and stifling regulations or to reserve requirements. They were not even bound by law to disclose financial statements, hold annual meetings or keep detailed records of transactions. Neither were the IMMCs subjected to any coordinated religious supervision (although most employed religious figures and used their fatwas to justify their practices).

Islamic Money Management Companies drew huge deposits by offering attractive dividends, typically 25 per cent, more than double what official banks offered, and became the preferred channel for the remittances of Egyptians working abroad. In a typical 'euphoric episode',[38] Egyptians accustomed to negative interest rates and unresponsive banks experienced something unprecedented: their savings were rapidly increasing in value; to boot, the companies were offering an unprecedented level of service. Religion was a strong selling point. Vigorous marketing campaigns warned against the ills of 'usurious interest', and associated their success with their religious orientation.

Although the companies made heavy use of religious language and symbolism, they do not seem to have had significant ties to political organizations. There were a few exceptions, such as the Al-Sharif group, which had long-standing ties to the Muslim Brothers.[39] Still, the possible political implications of an alliance with anti-governmental groups did not escape the government.[40]

Obviously, given the large number of such firms – about 200 at their peak – generalizations are hazardous: some were serious about their religious character, while others used it primarily as a marketing ploy. Some made legitimate and 'productive' investments while others were essentially speculative ventures. A few were from the start fraudulent operations.[41] The best-known and largest IMMC was Al-Rayyan (named after one of Islam's heavenly gates), which was fronted by a religious figure, but in reality controlled by the Abdul-Fattah brothers. Its early income had come from money changing, black-market currency trading as well as a few high profile commercial and industrial ventures, but it increasingly engaged in financial speculation. Such a mix of activities was typical of most Islamic Money Management Companies: the visible investments were in the productive sectors of the Egyptian economy (manufacturing, tourism, etc.), but the hidden ones involved speculation – primarily in gold, foreign currency and commodity markets. In addition, it looked like many deposits found their way into bank accounts abroad.

By 1985, the role of the IMMCs in the economy became critical. The government was then in the middle of a fiscal crisis, the official economy was in a recession, and the official banks were experiencing a shortage of funds. So, on the one hand, their role seemed salutary: they mitigated the effects of the economic crisis, providing the much-needed basic services that the official banking sector was unable to offer. On the other hand, the government realized that the Islamic Money Management Companies were a time-bomb waiting to explode. Central Bank governor, Ali Negm, was especially vocal in criticizing the companies and warning their depositors. Yet the companies remained defiant. In November 1986, following news reports about heavy losses incurred by Al-Rayyan, a run on deposits occurred. Al-Rayyan withstood the panic (reportedly with help from local banks and possibly from Saudi banks), but not without launching a counter-campaign against the government. In advertisements in Egyptian publications, it accused the government of plotting against it. When, in the following days, the Central Bank governor was replaced, Al-Rayyan claimed victory (though it was unclear whether the two events were connected).[42]

Yet despite the inability (or unwillingness) of the government to move decisively against the IMMCs, their dividend policy was clearly unsustainable. And indeed, as the competition heated up, they had to increase their 'dividends' (some offered over three per cent a month). It was a matter of time before many simply became huge pyramid, or Ponzi, schemes.[43]

The Egyptian society was deeply polarized. The 'new bourgeoisie' that emerged from the infitah, as well as returning migrant workers, were the beneficiaries of the new system. The traditional business establishment in contrast viewed the IMMCs as dangerous upstarts and as a potentially destabilizing force in the economy. Other splits occurred along religious and political lines. The more secularly inclined Egyptians viewed the

IMMCs as a vehicle for further Islamicization of the Egyptian society. A number of prominent political figures were now on the payroll of the major IMMCs; some were offered even more attractive 'dividends' than typical depositors. By the same token, certain segments of the media were kept at bay since they were increasingly dependent on large advertising and printing contracts. A propaganda war erupted between the official banking sector and the companies, which were accused of making false promises to investors and of being hypocritical, since they were using religion to enrich themselves. The IMMCs retorted that the official banks were simply jealous of their success, and that they were spreading rumours intended to cause their downfall. Throughout the 1985–8 period, despite a string of failures, politicians were unable to agree on the regulation of IMMCs.[44]

The official banking sector was strongly opposed to these new rivals. Its main argument was that the unregulated IMMCs engaged in unfair competition against the regulated banking system, and that their practices threatened the entire financial system. It should be noted that in the confrontation between the IMMCs and the official banks, Islamic banks, such as the Faisal Islamic Bank of Egypt, were on the side of the official banks, of which they were part. (To complicate things further, a number of conventional Egyptian banks had since the early to mid-eighties created Islamic branches of their own.) Still, on a number of occasions, IMMCs attempted to cross over into the official banking sector. Apparently, the only successful attempt was the acquisition by the Al-Sharif company of 30 per cent of the shares of the International Islamic Bank for Investment and Development (IIBID).[45] The Al-Rayyan group tried unsuccessfully to become a member of the International Association of Islamic Banks.

By 1988, the majority of IMMCs were facing problems of liquidity. Many of their owners fled the country. Under pressure from the International Monetary Fund, the government finally reined in the IMMCs, requiring them to maintain a capital-to-deposit ratio of 10 per cent, channel their accounts through commercial banks, and publish audited financial statements. But it was too late. By then a large number of Islamic companies had failed, or were beyond rescue. It was a matter of months before Al-Rayyan encountered the same fate. The impact on the Egyptian economy was considerable. By some estimates, $3 billion – 15 per cent of Egypt's GNP – had evaporated.[46]

Soon afterwards came the 1989 Tantawi fatwa, which was a mixed blessing for both conventional and Islamic finance.[47] It legitimated interest, and in the long-standing battle between Islamic and conventional banks, stood on the side of conventional banks. But from an Islamic banking standpoint, it helped ease the suspicions that had long surrounded all areas of finance. In particular, it drew attention to the role of secular experts and to the need for religious scholars to pay heed to them.[48] Thus, although controversial in the Islamic world, it was a milestone in the

evolution of Islamic finance. Challenging the dogmatic fixation on riba-as-interest, it allowed for a new pragmatism and set the stage for a growing convergence between Islamic and conventional finance.

4.5 The Growing Pains of Islamic Banks

Despite the Islamic injunctions against gharar (see Chapter 3), and despite the fact that Islamic finance frowned against short-term, solely profit-driven commodity investments, a number of Islamic banks engaged in dangerous speculation in gold, foreign currencies, and commodities. Many bankers invoked the lack of suitable investments, especially given the combination of worldwide recession and falling oil prices since the early eighties, as well as the absence of riba and the acceptability of investment in commodities. Inevitably, a number of banks suffered heavy losses. Some were on the brink of insolvency. Thus, the International Islamic Bank for Investment and Development (IIBID) incurred heavy losses speculating in US commodities markets and was temporarily taken over by the Egyptian Central Bank.[49]

Another setback was the collapse of the Bank of Credit and Commerce International (BCCI) in 1991. Although not itself an Islamic bank, BCCI had set up in 1984 an Islamic Banking Unit in London, which at its peak had $1.4 billion in deposits, and had generally made heavy use of Islamic rhetoric and symbolism.[50] More importantly, however, the scandal brought Islamic institutions into the international limelight and raised questions about the management and regulation of transnational banks. The Price Waterhouse report commissioned in the wake of the bank's closure revealed that of BCCI's $589 million in 'unrecorded deposits' (which allowed the bank to manipulate its accounts) the major part – $245 million – belonged to the Faisal Islamic Bank of Egypt (FIBE). This amount was supposed to be used for commodity investments, though there was no evidence that such investments were ever made.[51] Similarly, the Dubai Islamic Bank (DIB) had placed $86 million with the bank. Although neither FIBE nor DIB was suspected of wrongdoing, the image of Islamic banks suffered a blow. Islamic banks came under closer scrutiny, and post-BCCI international regulation tightened the screws on transnational banks, thus complicating the strategies of the main Islamic banking groups, Dallah Al-Baraka and DMI.[52]

The proliferation of problems highlighted the flaws in the Islamic banking system and the need for sound management practices. It also had a demonstration effect that strengthened the 'modernist' interpretation of the Shariah: the literal/legalistic interpretation – i.e., focusing on an unduly restrictive reading of the Shariah, focusing on the prohibition of interest – can lead to a large number of possibly worse transgressions such as fraud (ghosh) or speculation (gharar). It was thus a combination of internal problems and external events that led to a transformation of Islamic finance.

4.6 Towards a Second Aggiornamento

By the late 1980s, the global political economy had undergone a profound transformation which posed new challenges to Islamic finance. It is not an exaggeration to talk about a new aggiornamento, reflecting a radically different era, chaotic and still unsettled. Old hierarchies and political alignments have crumbled; a new economic order has emerged; the world of finance is unrecognizable. The second aggiornamento, still in the making, is somewhat amorphous and characterized by pragmatism. It can be defined by its diversity, multipolarity and convergence with conventional finance.

The early Islamic banks, organized under the umbrella of the International Association of Islamic Banks (IAIB), had a virtual monopoly on Islamic finance. They now constitute only one part of a much broader and much more diverse group of companies, most of which do not belong to the IAIB. New poles of influence have appeared. One such pole is Malaysia, whose political/economic profile and religious traditions are quite different from those of the countries involved in the first aggiornamento (Persian Gulf states, Egypt and Pakistan). At least until the 1997 Asian economic crisis, Malaysia was a 'model' economy, with a thriving middle class and growth rates approaching the double digits. Mahathir Mohammed, Malaysia's leader, harnessed Islam to his goal of economic growth through the embrace of high technology and modern finance. His brand of Islam was fused with other influences (nationalism, capitalism, 'Asian values') to produce a unique ideology of development.[53] His approach to Islamic finance was highly pragmatic. Rather than using what was Islamically acceptable as a starting point, he adopted the opposite approach, challenging the Malaysian ulema (learned men) to an ijtihad designed to generate new ideas. A number of Islamic research centres and universities engaged in a vast effort to legitimate modern finance, and in particular an 'Islamic capital market' using specially designed interest-free bonds and other securities.[54] Many Malaysian 'innovations' in that area are not deemed acceptable to Shariah boards in more conservative Gulf states.

In recent years, most Islamic countries – and a few non-Islamic ones – have encouraged the creation of Islamic financial institutions. But in devising a legal framework for their Islamic institutions, countries are no longer relying primarily on the guidance of the IAIB or the Islamic Development Bank (IDB), but on national interest considerations, with positioning in the global economy a key factor. Domestic factors and the diversity of national circumstances (including of course the impact of indigenous forms of Islam) have inevitably added to differences across countries. To put things differently, the assumption of the first aggiornamento was that there was a unique model transposable to all members of the 'umma', under the guidance of the IAIB and the IDB, that would (at least theoretic-

ally) serve as a basis for greater economic and political integration. In the current free-for-all, there is an additional, and contradictory, force at play: Islamic countries are repositioning themselves in the global economy, creating capital markets and responding to the demands of global financial regulation;[55] in the process, they are often in competition with one another.[56]

As for the convergence between Islamic and conventional finance, it is highlighted by five recent phenomena. First, a growing number of conventional banks are opening Islamic subsidiaries and/or 'Islamic windows', offering their customers a choice between Islamic and conventional products. Following a well-established trend, the Arab Banking Corporation, one of the largest Middle Eastern banks (which was founded jointly by Kuwait, Libya and the United Arab Emirates in 1980), announced in late 1997 the creation of an Islamic unit. Virtually every conventional bank in the Middle East and the Islamic world offers at the very least some Islamic investment options.

Second, financial institutions from outside the Islamic world are now creating Islamic subsidiaries or offering Islamic products. Financial firms that aspire to become global brands – Citicorp, Merrill Lynch – have long-standing ties with Persian Gulf states, but have recently felt the need to tap Islamic middle classes. Citicorp's establishment of an Islamic subsidiary in Bahrain in 1996 has been closely watched within the international financial community. Kleinwort Benson, ANZ Grindlays, Goldman Sachs and ABN Amro are among those Western firms active in Islamic finance.

Third, many Islamic institutions are aiming their increasingly sophisticated and diverse products at non-Muslims. Financial institutions are creating products not only on the basis of their being Islamically acceptable, but also on the basis of their being intrinsically attractive to buyers of conventional products. In the words of Majed Al-Refai, chief executive of the Bahrain-based First Islamic Investment Bank: 'Our aim is to create credit-rated medium-to-long term investment tools which are comparable with existing conventional products, so that financial advisors can advise their clients to invest with us on the basis of returns, rather than because they are Islamic.'[57]

Fourth, a growing number of Islamic banks have been established outside the Islamic world, in order to cater to local Islamic communities. Since the 1980s, such institutions have been created in Europe, the United States and Australia. Today, Islamic banks exist in virtually all parts of the world. In 1997, Russia announced the creation of its first Islamic bank. Badr Bank (with 51 per cent of the shares belonging to Russian citizens but with most of the $20 million start-up capital coming from Iran, Saudi Arabia, Kuwait, Qatar, the Sudan and Egypt) said it would initially invest up to $60 million in various long-term projects in the arms industry, space technology, shipbuilding and industrial ecology. Its investments would

include a major project in the Baikal-Amur railway region, an economically depressed area of eastern Siberia with very high unemployment. Another stated goal was to invest in infrastructure projects to boost trade links between Russia and the Middle East and Southeast Asia.[58] And in 1998, the autonomous region of Ningxia announced it was about to establish China's first joint-venture Islamic bank, in association with an unnamed Saudi Arabian bank.[59]

Fifth, much of the new ijtihad on Islamic finance is conducted in cooperation between conventional and Islamic institutions, often outside the Islamic world. Perhaps the most ambitious research on Islamic finance is now conducted at Harvard University. A number of programmes have been established in the last few years under the aegis of the Center for Middle Eastern Studies (CMES), in cooperation with the Harvard Law School and Harvard Business School, and with financing from such institutions as the National Commercial Bank, the Islamic Development Bank, Wellington Management and Goldman Sachs. In December 1995, the Harvard Islamic Finance Information Program (HIFIP) was started with financing from the Islamic Investment Company of the Gulf, Bahrain (IICG), a member of the Dar Al-Maal Al-Islami group. It is 'committed to the collection, analysis and dissemination of information on the Islamic financial sector' and aims to 'promote research and development in the field of Islamic finance, sponsor research projects which investigate new trends, strategies, and methods in Islamic finance' with 'particular emphasis given to studies which investigate how existing financing methods available in conventional finance can be applied to Islamic finance and vice versa'.[60]

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18. See Chapter 2.
19. Galloux, p. 45.
20. See Chapter 6.
21. Wohlers-Scharf, p. 81.
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25. Kiren Aziz Chaudhry, *The Price of Wealth: Economies and Institutions in the Middle East*, Cornell University Press 1997, p. 3.
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41. Parigi, pp. 83–105.
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43. Charles Ponzi developed a scheme in Boston in 1919 and 1920 in which he would promise an 'investor' high rates on his money (40 per cent for 45 days), then would borrow larger sums from later investors, take a cut, and use the remainder to pay the interest to earlier investors.

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5

ISLAMIC FINANCE AND THE GLOBAL POLITICAL ECONOMY

What is the significance of Islamic banking from the standpoint of international politics and economics? Superficially, the creation of the first Islamic banks could be seen, especially in the context of the oil crisis and the calls for a New International Economic Order, as a challenge to the Western banking system. Just as superficially, as we saw, it is common to say that Islam – and one would assume its economic manifestations – is incompatible with the New World Order that has emerged with the end of the cold war.[1]

This chapter attempts to place the development of Islamic banking in its broader international political and economic context, showing that, paradoxically, the first aggiornamento was firmly embedded within the Western banking system of the era, and that, even more strikingly, the new global economy which has emerged with the end of the cold war has allowed Islamic banking to thrive.

5.1 The Political and Economic Context of the First Aggiornamento

Modern Islamic banking would probably not exist were it not for two political–economic developments: pan-Islamism, and the increase in oil prices. At the centre of both was Saudi Arabia's King Faisal. It is thus appropriate that the leading network of Islamic banks be named after him, even though the Faisal Bank is still not allowed to operate as a commercial bank in Saudi Arabia.

5.1.1 Pan-Islamism

For all the talk throughout Islamic history about the 'umma' (the Islamic nation, or the community of believers), pan-Islamism as a modern political movement did not begin in earnest until the 1960s at the time of the 'Arab cold war'.[2] Egypt's President Gamal Abdel Nasser was then a champion of the Third World's struggle against Western colonialism. His brand of nationalism, secularism and socialism was embraced by other newly

independent Islamic states such as Algeria and Indonesia. The relations between Egypt and Saudi Arabia had their ups and downs, but for most of the 1960s, the two countries were at odds. Saudi Arabia was a conservative Islamic monarchy with strong ties to the West. It served as a sanctuary for many of the Muslim Brothers leaders who suffered from the repression of Nasser's regime. Egypt reciprocated by offering asylum to insubordinate members of the Saudi royal family. The Yemeni civil war (1962–7), during which both countries fought on opposing sides, became the focal point of the 'Arab cold war'.

King Faisal sought to trump Nasser's pan-Arabism by sponsoring a pan-Islamic movement, the Muslim World League, and used the pilgrimages to Mecca to forge ties with Islamic leaders, both inside and outside the Arab world. To oppose Nasser's message of Arab and Third World solidarity, he proclaimed the doctrine of Islamic solidarity.[3] In addition, he extended substantial amounts of aid to non-Arab Islamic countries in Asia and Africa, and embarked on a series of high-profile visits to Islamic capitals. Upon one such visit to the Shah of Iran in December 1965, the Saudi king was accused by the Egyptian press of using Islam 'as an instrument to combat Arab unity'.[4]

A number of events set the stage for an Islamic renewal, thus enhancing Faisal's position. The most dramatic was the six-day war of June 1967. Significantly, in his first speech following the crushing Arab defeat, a humbled Nasser made a specific reference to religion.[5] In the soul-searching that followed, many of the principles that had governed Egypt's policy were called into question. It became common to say that the Arabs were punished for straying from the path of true Islam.[6] Egypt embarked on a more moderate course and Saudi Arabia's stature within the Islamic world grew. Then in 1969, a deranged Australian set fire to the Al-Aqsa mosque in Israeli-occupied Jerusalem. In the aftermath, King Faisal, by then the unquestioned leader of the nascent pan-Islamic movement, called for an Islamic summit in Rabat, Morocco, at which it was agreed to form a permanent Islamic organization. The Organization of the Islamic Conference (OIC) was born in 1970, the same year Nasser died. And unlike the June 1967 war, which was fought in the name of Arab nationalism, the October 1973 (known as the Ramadan war in Arab countries and as the Yom Kippur war in Israel) was full of religious symbolism. It was, for example, code-named 'Badr' – the name of Mohammed's first decisive victory over the Meccans.

By the mid-1970s, pan-Islamism had become a powerful movement, helped in no small part by the newfound wealth of Saudi Arabia. In such countries as Turkey and Pakistan, which until then had limited ties to the Arab world, Islamic solidarity became an important foreign policy theme 'as the Muslim oil-producing states of the Middle East become important markets (especially for manpower) and important sources of economic

aid'.[7] The rapprochement between Pakistan and Persian Gulf states was especially significant since, as we saw, it was in Pakistan that the bulk of the early research on Islamic banking had been conducted. Throughout the 1970s, '[w]hile Saudi Arabia and other Gulf states provided the cash, Pakistan has provided much of the manpower, and much of the zeal, for the network of supranational 'Islamic' institutions that has developed ... under the umbrella of the Organization of the Islamic Conference.'[8] Interestingly, it all occurred during the rule of Zulficar Ali Bhutto – to whom the labels of 'secular' and 'socialist' are usually affixed – who made numerous trips to oil-producing countries, emphasized the theme of Islamic brotherhood in his speeches, and hosted the Islamic summit conference in Lahore, during which the idea of the creation of an Islamic bank was adopted. (That summit was also the occasion of the reconciliation between Pakistan and the newly created Bangladesh, following an appeal in the name of Islam by Egyptian President Anwar Sadat.)[9]

5.1.2 The Petrodollar Windfall

Although Nasser's policies following the 1967 war were marked by relative moderation and pragmatism, it was under his successor Anwar Sadat that Egypt, timidly at first and then increasingly boldly, embarked on a new course: an Egypt-first stance that meant the abandonment of Nasser's 'meddling' in other countries' affairs; distancing from the Soviet Union (Soviet advisers were expelled in 1972, but the Soviet Union nonetheless supported Egypt during the 1973 war); and de-Nasserization policy at home, primarily the abandonment of socialism and embarking, especially after 1974, in a policy of 'infitah' (open door).

All those policies were welcomed by Saudi Arabia, and the two countries entered into an era of close cooperation. King Faisal granted generous financial assistance to Egypt, recognized Egypt's military role as the main confrontation state vis-à-vis Israel, and coordinated his oil policy with President Sadat. Cooperation on military and oil matters was crucial since the embargo and oil price increases of 1973–4 were closely linked to the Arab–Israeli war of October 1973.

By the early seventies, the balance of power between oil producers and consumers and between governments and oil companies had shifted. Because of uninterrupted economic growth and the increased reliance on oil – at the expense of other energy sources – worldwide demand was very strong. Oil producers realized that with high inflation and a falling dollar, their oil receipts were steadily dwindling. (In real terms, the price of oil, which had remained stagnant for decades, was going down.) At the same time, oil-producing countries had become more assertive and better equipped to negotiate with oil companies: they now had nationals who had studied petroleum engineering, law or business administration in Europe

and the United States; they had also accumulated enough financial reserves to enable them to survive a showdown with oil companies. In the period between 1970 and 1973, they were thus able to obtain better terms: greater control over oil policy, higher prices, greater share of receipts, and even gradual nationalization, which increasingly transformed the role of foreign oil companies from all-powerful intermediaries and owners or part-owners of oil resources, to mere service providers, hired at the discretion of governments, to explore for, extract, refine and sell the oil.[10]

So, just as King Faisal was kept apprised of war preparations, Anwar Sadat was strongly pressing him to use the 'oil weapon' – that is, to create a linkage between the price, indeed the availability, of oil, and the Arab–Israeli conflict.[11] A conjunction of political and economic factors led to the oil embargo in October 1973 against countries supporting Israel (including the United States), and the quadrupling of the price of oil between October and December of that year. In what is commonly considered one of the most massive transfer of wealth in modern times, the mid-seventies were dominated by talk of a New International Economic Order (NIEO), more specifically of new relations between North and South and of Southern and particularly Islamic solidarity. In that context, Islamic banking went from a vague, somewhat utopian, idea to reality.

5.1.3 Relations with the US and the West

In 1975 Hans Morgenthau, then the leading American theorist of international relations, said:

> The control of oil, the lifeblood of an advanced industrial state, by potentates who have no other instrument of power and who are accountable to nobody, morally, politically, or legally, is in itself a perversity. It is a perversity in the sense that it defies all rational principles by which the affairs of state and the affairs of humanity ought to be regulated to put into a few irresponsible hands power over life and death of a whole civilization.[12]

The tone of Morgenthau's statement, and others by similarly learned people – let alone those of lesser learned ones – suggests an unwarranted attempt to somehow cripple if not destroy 'the free world' and its economy.

The great paradox of the developments presented in the previous pages is that the main players involved – Anwar Sadat, King Faisal, the Shah of Iran – happened to be the strongest supporters of the United States and the West, and were all keen on having their national economies firmly embedded within the US-centred international economic framework. Sadat and Faisal felt that the 'oil weapon' was a means to break a political deadlock and achieve a more equitable distribution of wealth between North and South. On the extent of the increase of oil prices, Saudi Arabia

was decidedly a dove. Indeed, one of the lesser-known facts about what is generically considered an 'Arab' price hike was that, at the fateful December 1973 meeting of the Organization of Petroleum Exporting Countries (OPEC) in Tehran, the two main hawks were Iran and Venezuela – both non-Arab countries and both at the time squarely within the US 'sphere of influence'.[13] The hawks saw no contradiction there, insofar as they considered the new prices consistent with the rules and logic of the free market. Perhaps a bit disingenuously, the Shah of Iran frequently reiterated his concern that the West was too dependent on oil, and that only significantly higher prices would lead to less waste and to a more resolute search for alternative sources of energy. Saudi Arabia had good reasons to lead the doves. It was sparsely populated and did not need all the additional income. Also, having the largest oil reserves in the world, it was worried that too steep a rise would encourage the development of alternative sources of energy which in time might altogether supplant oil. Perhaps most importantly, Saudi Arabia, along with other Gulf states, was also heavily invested in international markets and was economically and militarily dependent on the United States. Crippling the US and the world economy would be self-defeating. When in the following years the Shah of Iran pushed for further price increases, Saudi Arabia refused to comply, for a time creating a two-tiered price system within OPEC.[14]

Overall, the relations between Saudi Arabia and the United States had been very close, although they were marred by differences over the US's staunch support for Israel. The strong bilateral ties were reinforced by the official visits of Faisal to Washington in 1966 and 1971, as well as by Nixon's visit to Riyadh in July 1974 at the height of the Watergate scandal and shortly before his resignation. In the context of the cold war, and despite the events of 1973, Saudi Arabia was firmly in the American camp. In the words of George Lenczowski:

> The two countries had a long history of mutual cooperation based on common concerns and complementary interests. Both were anticommunist and opposed to radical revolutionary movements anywhere in the world; both looked for stability and security in the Arabian Peninsula and the Persian Gulf; and both were interested that Saudi petroleum should flow uninterruptedly to the consumers in the industrialized democracies for the mutual benefit of the buyers and the sellers. The fact that a purely American company, Aramco was the sole operator of oil fields on Saudi territory added to the closeness of this relationship.[15]

Edward Mortimer observed that, for King Faisal, as for his successors, 'the interests of Islam are in the last resort identified with those of the "free world" – which Faisal saw as the Christian world, ruled by "people of the book" – against those of atheistic communism'.[16]

So despite policy differences over Israel and an oil policy which provided, among other things, for a gradual nationalization of Aramco, cooperation between the two countries actually increased, especially in military and financial matters. Since 1974, the Saudis have significantly increased their purchases of American weapons and have chosen to invest a significant part of their newfound wealth in US Treasury Bonds, while maintaining most of their deposits in American banks.[17]

It is thus not surprising that despite the heated rhetoric, US leaders such as Secretary of State Henry Kissinger considered the oil crisis to be a benign development that would further the geopolitical position of the United States.[18] His view was that, in relative terms, the US was less dependent on oil than Europe and Japan, and that most of the oil windfall would find its way back into the United States in the form of military and civilian contracts or Treasury Bonds purchases. From a geopolitical perspective, the Shah of Iran, the leading hawk on oil prices, was designated as the regional 'policeman' and granted 'blank cheque' privileges in his shopping sprees: Iran, then considered to be a rock of stability in a highly unstable area, became the only country allowed to purchase, on a cash basis, any weapons it wanted. In 1978–9 the second 'oil shock' occurred, triggered by riots and strikes in Iranian oil fields, and later by the Iranian revolution. Fearing a domino effect in the region, President Jimmy Carter formulated in January 1980 what became known as the Carter Doctrine:

> Let our position be absolutely clear. An attempt by any outside force to gain control of the Persian Gulf region will be regarded as an assault on the vital interests of the United States of America, and such an assault will be repelled by any means necessary, including military force.[19]

The alliance between the United States and Saudi Arabia and other Persian Gulf states was consolidated as these countries became more dependent than ever on American protection.[20]

5.2 Islamic Finance in the Global Economy

By the mid-1980s, the circumstances that had given rise to Islamic banking had subsided. More specifically, oil revenues had fallen to such an extent that most Islamic countries were experiencing serious fiscal and balance of payment problems. In Saudi Arabia, for example, oil revenues declined from a high of $120 billion in 1981 to $17 billion in 1985.[21] In most countries, the economic downturn had dramatic political and economic consequences: budget cuts, tax increases, cancellation of contracts, sharp drops in labour remittances, etc. Yet Islamic banking kept growing.

This section considers the trends that help explain the recent growth of Islamic finance: the emergence of a global economy which limits the

options of national governments and is characterized by new norms and a new ideology; the transformation of the financial sector, whereby the lines between commercial banking on the one hand, and investment banking as well as other financial activities on the other, are increasingly blurred; the rise of Islamism, which has put pressure on governments throughout the Muslim world to allow for religiously inspired financial products and institutions; and the very preoccupations – ethical, political, economic and social – resulting from the excesses of globalization and the search for correctives.

5.2.1 The Global Economy and its Ideology

The 1970s were characterized by the emergence of a regional economy within an international system still dominated by the confrontation between the United States and the Soviet Union. The petrodollar windfall had reconfigured economic relations within the Islamic world. A sharp increase in trade, aid, and labour remittances transformed the economies of the Muslim world. The poorer countries could also count on financial aid from one of the superpowers, and sometimes from both. In the wake of the Camp David accord, Egypt became the second largest recipient of US aid (after Israel), while countries such as Syria or Iraq received significant aid from the Soviet Union. In the wake of the oil bonanza, the abundant deposits in international banks were often 'recycled' into loans to governments, which in those years of statism played a central role in economic development.

Throughout the 1980s, both the regional economy and the cold war system slowly disintegrated. The debt crisis (starting in August of 1982) led banks to reconsider their commitment to sovereign lending.[22] With the accession to power of Mikhail Gorbachev in 1985, East–West relations were transformed. The fall of the Berlin War in November 1989 and the disintegration of the Soviet Union in December 1991 marked the end of the cold war. Within the Islamic world, the Gulf War marked the end of the regional economy.[23]

The changes leading to a New World Order were accompanied by an ideological shift. Traditional views on development had already been under sharp attack.[24] Since 1979, the World Bank had changed its focus from financing individual projects to transforming entire economies. With the Philippines as its first guinea pig, it set out to transform economic (and hence political) 'structures' in exchange for aid.[25] And since the debt crisis which spread from Mexico to much of the developing world, the International Monetary Fund (IMF) had become a sort of 'global bankruptcy judge', disbursing funds only on condition that countries adopt 'structural adjustment' policies.[26] Both in the cases of IMF and World Bank plans, the typical package included addressing macro-economic imbalances and

implementing sound fiscal and monetary policies, reforming the public sector, modernizing the supervisory and legal infrastructure, liberalizing financial markets, eliminating subsidies, promoting the free flow of capital and investment, etc. It should therefore come as no surprise that some have called such 'structural adjustment programs' the equivalent of 'a foreign-controlled coup in slow motion'.[27]

The new paradigm was strengthened by the collapse of Communism in Eastern Europe and the implosion of the Soviet Union, which were interpreted as the victory, in the battle of ideas, of capitalism and the market economy over socialism and central planning.[28] Old dogmas regarding the respective roles of states and markets were turned on their head: government leaders were now seen as neither able nor willing to promote the public good; state controls could only encourage inefficiency, stifle entrepreneurship and delay reform. What came to be known as the 'Washington consensus' was shared by the US and other industrialized countries and by international organizations. The state, once seen as the provider of solutions, was now perceived as the major obstacle to development. All attempts at central planning, and even milder forms of industrial policy, were doomed. State-led policies, protectionism and import-substitution had to be replaced by privatization, deregulation, and an export orientation. Foreign 'experts', some of whom – for example, Harvard's Jeffrey Sachs – achieved celebrity status, advised governments, often with disastrous results, on the reform process and the transition to free-market economies.[29]

Reform was the sine qua non of obtaining access to international financing and to global markets. In order to obtain financial help from international organizations, or to be allowed to join the World Trade Organization (WTO), governments had to embrace – perhaps, more accurately, claim to embrace – the new ideology of reform. Governments also came under the surveillance of markets. Embracing the new ideology was more a matter of necessity than choice. With the drying-up of external aid and the virtual end to sovereign loans by banks, the only option governments had was to borrow on the international markets. An added incentive for reform was related to a new phenomenon – the grading of countries and their debt by rating agencies. Throughout the 1990s, Moody's and Standard and Poor's awarded ratings to emerging markets, based in large part on an evaluation of how well the reforms demanded by 'the markets' and their proxies were implemented. The cost of a bad rating is very high: punishing interest rates, perhaps even the outright inability to tap international markets.[30] At a time when private and public borrowers are fiercely competing across the globe to attract capital, in what John Maynard Keynes used to refer to as a 'beauty contest', poorly rated countries are likely to be shunned.

In short, the after-effects of the debt crisis and the end of the cold war,

along with the impacts of deregulation and technological change, have recast the choices available to national governments. Unless they prefer autarky, countries are forced to conform to the dictates of the global economy. Most Islamic countries are heavily indebted and increasingly dependent on the outside world for financing, and the political and economic clout of bankers and other financiers is on the rise.[31] In order to raise funds in the international markets, or to obtain aid from the International Monetary Fund or the World Bank, governments must adopt policies that conform to the new international orthodoxy (economic austerity, liberalization of trade and capital flows, privatization, deregulation and dismantling of the public sector).[32] Even so-called 'rogue states' such as Iran or the Sudan, lest they be financially starved, have to deal with the IMF and the World Bank and thus comply with demands related to economic policy.

The tidal wave of liberalism was somewhat late in reaching the Islamic world, but it is now clearly there.[33] The 'alliance' between Islamists and liberals is justified by the existence of a common target: the all-powerful (and secular) state. Two areas of convergence between the Islamist critique of statism and the Washington consensus should be emphasized. First is the Islamic commitment to private property, free enterprise and to the importance of contracts, as opposed to state-led economic policy and the arbitrary decisions that go along with a strong state bureaucracy. In many countries, Islam has become the tool of entrepreneurs seeking to get around restrictive regulation, and an instrumental factor in privatization and deregulation – and the best excuse to disengage the state from the economy. Insofar as financial liberalization is 'the process of reducing government control over the allocation of credit',[34] Islamic bankers were bound to make common cause with economic liberals. Second is the parallel between the 'privatization of welfare' (through reliance on zakat and other religiously based redistribution schemes) advocated by Islamists, and the downsizing of the state that is central to the new ideological consensus. Private virtue thus meets efficiency: by helping the poor, the wealthy become better human beings; and the voluntary provision of charity reduces the need for public welfare organizations that are usually costlier to run.

This is not a new phenomenon. In medieval Muslim society, the Shariah was often used as a shield for private property against arbitrary confiscation.[35] Today the merchant classes are using the Koranic emphasis on private property rights, and Islam's positive view of commerce and profits, to pursue policies of privatization and deregulation. Even Islamic Republics have on occasion openly embraced neo-liberalism. Thus, in Sudan between 1992 and the end of 1993, Economics Minister Abdul Rahim Hamdi – a disciple of Milton Friedman and incidentally a former Islamic banker in London – did not hesitate to implement the harshest free-

market remedies dictated by the International Monetary Fund. He said he was committed to transforming the heretofore statist economy 'according to free-market rules, because this is how an Islamic economy should function'.[36]

5.2.2 The Transformation of Banking and Finance

For most of the past decades, the world of finance was neatly divided between commercial banking on one side and investment banking and other forms of finance on the other. In the United States, the 1933 Glass-Steagall Act, for example, prevented the two types of institutions from encroaching on each other's territory. Typically, commercial banks were regulated like utilities. They benefited from government-sanctioned oligopolies, as products, rates, and geographic expansion were tightly regulated, and deposits were up to a certain level covered by insurance. The main source of profit for commercial banks came from interest income (the difference between interest earned on loans and interest paid on deposits). Since the 1970s, the nature of banking has started to change, and virtually every country has embarked on a wholesale overhaul of its banking system.[37] 'What is going on now is a revolution in the way finance is organized', wrote Adrian Hamilton, 'a revolution in the structure of banks and financial institutions and a revolution in the speed and manner in which money flows around the world'.[38] This revolution was made possible by the impact of technology on financial services. According to Peter Dicken, 'information is both the process and the product of financial services. Their raw materials are information: about markets, risks, exchange rates, returns on investment, creditworthiness. Their products are also information: the result of adding value to these informational inputs'.[39]

Five major trends capture change in international finance. First is the impact of the new dominant ideology on financial policy. In contrast with the previous belief that strict government controls were necessary, a new ideology stressing the importance of free markets asserted itself in the mid-seventies in the United States and soon became the new worldwide orthodoxy. Since the US decision to deregulate commissions on securities transactions on 1 May 1975, and then to phase out interest-rate controls and credit restrictions in landmark pieces of legislation enacted in 1980 and 1982, an irreversible process of deregulation has been underway. European countries followed suit, most dramatically with the British Big Bang of 1986, and later with the creation of a single European financial market. Alone among industrialized countries, Japan engaged – at least until its 1997 announcement of a phased-in 'Big Bang' – in a reluctant, incremental and tightly controlled process of deregulation.[40] As for emerging markets, most underwent during the 1980s a conversion to free-market economics. As we saw earlier, the liberal ideology spread to most of the world and a huge

privatization effort has since been underway.[41] Latecomers had a tendency to embrace the new ideology with a vengeance.

Second is the globalization of finance brought about by technological change and the opening of national markets to foreign competition. Richard O'Brien has written about the 'end of geography', whereby 'financial market regulators no longer hold full sway over their regulatory territory',[42] and firms recast their strategy based on a global marketplace. With the lifting of restrictions on capital movements, financial markets are increasingly interconnected. While interest rates are still far from achieving full convergence,[43] they are now increasingly sensitive to market forces and global capital movements.[44] In addition, governments now find themselves under the constant surveillance of 'the markets' via such proxies as rating agencies, securities analysts and the like.[45] Not since the glory days of the gold standard (1870–1914) have countries been so subjected to the whims of international capital. It is estimated that $1.25 trillion change hands every day in the foreign exchange markets. In an era of quicksilver capital, foreign investors have the power to enter and exit a market as they please, and little can be done by governments to stem the flow of short-term and often speculative funds.[46]

Third is the changing dynamics of competition. Deregulation and liberalization have intensified competitive pressures and blurred the lines within the financial sector. The cosy world of national oligopolies started fading with the erosion of the near-monopoly of banks on the intermediation process (the conversion of savings into loans). Banks were squeezed on both sides of their balance sheets. On the asset side, they lost the core business of lending to large (and even not-so-large) corporations, to commercial paper and junk bonds. Indeed, major corporations discovered that commercial paper was a much cheaper source of short-term working capital – as well as a higher yielding short-term investment for their own excess cash.[47] The amount of commercial paper outstanding increased fourfold in the 1970s to $124 billion, and then quadrupled again in the 1980s to $570 billion as of December 1990. By contrast, all money centre banks' commercial and industrial loans at that time were only $322 billion.[48] Banks also lost high-margin borrowers when second-tier corporations started issuing junk bonds mostly under the aegis of ill-fated Drexel Burnham Lambert.[49] On the liability side, depositors left banks in droves for higher yields in mutual funds, money market funds, or even stocks and bonds.[50] All these developments put tremendous pressure on banks' margins. Having lost their core businesses, indeed their franchise, they had to venture, initially without much success, into new territories, for which they were singularly – whether because of their inherently conservative culture, or regulatory strictures to which they were still subjected – ill-prepared.[51]

With the commercial banks in competition with securities firms, insurance companies, mutual funds, pension funds, hedge funds, etc.,

investors faced a growing range of choice. Increasingly, loans and other financial assets were securitized, that is, converted into tradable securities that can be bought and sold on the market. Fierce competition brought forth industry consolidation. Unable to compete, a growing number of firms fell by the wayside as a few players grew bigger, typically evolving into conglomerates combining banking, securities, and insurance activities in a single group.[52] Most countries have been moving towards a German-style universal banking model, where a financial institution can be at once a commercial bank, an investment bank, and a shareholder in industry.

In the United States, while Glass-Steagall is still on the books – although there have been, since 1991, annual Congressional attempts to abolish formally the 1933 legislation – barriers separating various types of finance have been slowly but surely disappearing. Commercial banks have acquired other types of financial institutions, and have reinvented themselves. Among the first to move away from traditional commercial banking were J. P. Morgan and Bankers Trust, the latter redefining itself as a 'risk manager' and creating a variety of new 'derivatives' designed to fulfil a variety of commercial and investment needs.[53] Similarly, John Reed, the chairman of Citicorp – usually considered to be the most innovative commercial bank – redefined money as 'information on the move'. Leading banking experts even argued that '[t]he commercial bank – the institution that accepts deposits payable on demand and originates loans – has outlived its usefulness and is in terminal decline'.[54] Such experts as consulting firm McKinsey's Lowell Bryan suggested that in the future all loans could be securitized. As a result banks would no longer be necessary, and could be 'broken up'.[55] To be sure, banks have not disappeared, but their share of the broad financial sector has steadily dwindled. For decades, commercial banks had somewhere in the order of magnitude of 70 per cent of the financial assets of the United States. The share has now fallen to about 30 per cent.[56]

By the same token, innovation in products and risk management techniques have taken centre stage. Deregulation and technological change allowed the creation of a wide array of financial products. Hence the explosion of derivatives – products such as swaps, options and futures whose value is derived from an underlying asset. 'Financial engineers' are now in a position to create an infinite variety of new financial products through a process of slicing and splicing. For example, the interest and principal components of a bond can be split and sold separately, or they can be combined with other instruments and packaged as a single product. Initially devised as hedging devices, many such products have in fact amplified the risk exposure of their users. With the proliferation of derivatives, risk management and control are now at the core of financial strategies. Increasingly, risk management is global, cutting across products, countries and legal entities.[57]

Fourth is the new relation between finance and economics. Until recently, finance was a reflection of the underlying real economy. Increasingly, the relationship has been reversed. Economics now seems driven by finance.[58] In many respects, there is even a disconnection between finance and the underlying economic reality, posing new risks to the economy and new challenges to governments who now ponder John Maynard Keynes's famous statement: 'Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation'.[59]

Fifth is the new power of central banks. Once relegated to a purely technical role and typically confined to being an appendage of the Ministry of Finance, central banking has become a locus of economic, and indeed political, power. The prototype of the new central banker is Paul Volcker, who chaired the Federal Reserve Bank between 1979 and 1987, and whose anti-inflation policy became legendary.[60] As price stability came to define the new orthodoxy of economic policy, the central banks were bound to became the guardians of the dogma. The underlying rationale was that vote-seeking politicians were spendthrift by nature, and that only 'independent' experts could insulate monetary policy from political pressures. So despite occasional criticisms of the growing power of unelected technocrats, a number of countries have moved to grant independence to their central bankers, considerably increasing their power in the process.[61] Between 1989 and 1998, more than 25 countries have upgraded the legal independence of their central banks.[62]

Based on all the above, we can see how the new world of finance has facilitated the growth of Islamic finance. Where interest income was once the cornerstone of banking, its relative importance has steadily declined in recent years. As a result of competitive pressures and thinning margins, most financial institutions have increasingly been relying on fee and commission, rather than on interest, income. For traditional banking operations – deposit-taking and lending – banks have discovered that tacking on fees was as inconspicuous as it was lucrative. But more significantly, banks are now engaged in financial operations – such as the creation and sales of derivatives and other new products – that do not directly involve interest. The downgrading of interest has allowed banks to sidestep – to some extent – the most controversial aspect of banking and move beyond inconclusive debates about riba.

Another striking development is the convergence between the profit-and-loss sharing logic of traditional Islamic finance and many modern financing techniques. Indeed, modern finance has seen a sharp increase in risk-sharing arrangements, along the lines of the merchant banking or the venture capital model, where the financier is no longer a lender but a partner.[63] And the financial innovation made possible by deregulation allowed the creation of specially tailored Islamic products. A few years ago,

financial institutions could only sell a narrow range of financial products. Now there are far fewer constraints on the products that 'financial engineers' can devise. In the wide array of available derivatives or mutual funds, there is a product for every need, religious or otherwise.[64]

5.2.3 The Rise of Islamism

The Islamic revivalism phenomenon has challenged most of the assumptions of Western liberal secularism and development theory. In an influential study of the Middle East published in 1958, Daniel Lerner pronounced the 'passing of traditional society'.[65] An entire generation of scholars of the Middle East and the Islamic world viewed the march of secularization and Westernization as inexorable. As we have seen, political Islam had launched its comeback at least from 1967. From the early seventies, even pro-Western, secular leaders such as Anwar Sadat in Egypt or Zulficar Ali Bhutto in Pakistan had actively courted Islamic leaders and made increased use of religious symbols in politics. But it took the Iranian revolution of 1978–9 for the scholarly community outside the Islamic world to take notice. Still, with the first rumblings against the Shah, most 'experts', ignoring the happenings in the holy city of Qom and concentrating instead on the 'viable alternatives' for Iran's future – the military, the Communists, secular nationalists – considered an Islamic revolution to be a logical impossibility. When the Ayatollah Khomeini rose to prominence during his brief exile in France, few imagined that he would be anything more than a figurehead or a unifying but politically inconsequential symbol.[66] Predictably, the Iranian revolution brought about a pendulum swing in outside perceptions of Islam. Once ignored, Islam became a ubiquitous and monolithic threat.[67]

The brand of Islam best known outside the Islamic world is revolutionary or radical, and usually anti-Western. Since the Iranian revolution, a number of developments have highlighted the political dimension of Islam. Only a few months after an Islamic republic had been proclaimed in Iran, the Grand Mosque in Mecca was seized by religious extremists. In 1981, Anwar Sadat was assassinated by an Islamist organization which argued that it was its religious duty to do so since, in its view, jihad was the sixth pillar of Islam.[68] In Syria, increased activity of the Muslim Brothers resulted in the Hama massacres of 1982.[69] Throughout the mid-eighties, 'Islamic terrorism' took centre stage. A number of terrorist incidents, inside and outside the Muslim world, were traced to Islamic extremists or to one of the other 'rogue states' (at various times, the list included Iran, Iraq, Libya, Syria and the Sudan). The long-drawn hostage crisis in Lebanon, where Westerners were kidnapped by Hezbollah, a Shia party of Iranian obedience, was a daily reminder of the dangers of Islamic 'fundamentalism'. During the Gulf War of 1991, although most Islamic governments

were part of the US-led coalition, Islamic public opinion seemed deeply divided. The presence of foreign troops in Saudi Arabia, the birthplace of Islam, was especially controversial. Later that year in Algeria, the Algerian Islamic Salvation Front (FIS) was poised to sweep the Algerian parliament in the first open elections in the history of the country, when the electoral process was cut short, touching off a bloody civil war. Throughout the Islamic world, Islamic parties and organizations had burst upon the political scene. Some were part of the existing institutional and electoral system, others operated outside of it. Even secular Turkey had a year-long experience with an Islamist prime minister.

Religious sentiment though ran deeper and went beyond politics, although private and religious manifestations of Islam seldom make headlines. In reality, throughout the Muslim world there had been increased manifestations of religious sentiment that were quite diverse – ranging from demands for an Islamicization of political life to a rise in 'pietism' – and different from the Iranian model. Thus, while Hamas, the Hezbollah or the Taliban are household words, few people outside the Islamic world have ever heard of the Jamaat Tabligh which, in terms of numbers and impact, far outstrips fundamentalist organizations. According to Yahya Sadowski:

> In part precisely because it is so apolitical, governments from Tunisia to Pakistan have not only tolerated but encouraged Tabligh's spread. After putting down strong roots in India, it grew rapidly across Pakistan, Afghanistan, Bangladesh, and Sri Lanka into Southeast Asia. It is one of the three movements that led the Islamic revival in Malaysia and plays an important role in Indonesia as well. It is highly popular among Muslim minorities in the West, including America, England, and France. It has a firm foothold in parts of the Middle East as well, though it has not yet spread as widely there as in other parts of the Muslim world.[70]

Such aspects of the Islamic revival are reflected in increased emphasis upon religious observance (mosque attendance, fasting), religious programming on television, as well as dynamic daawa (missionary) movements aimed at converting non-Muslims and bringing Muslims to deepen their religious knowledge and commitment. Islam is also playing a large role in civil society. It has penetrated deeply within associations, ranging from trade unions to civic organizations to student groups, and is now part of the mainstream of society.[71]

Many reasons for such reawakening have been suggested: the vacuum left by secular ideologies, socialism in particular, which were discredited both politically and economically, as well as the moral outrage at the extent of oppression and corruption; the attempts by certain groups, especially among the lower classes and those traditionally under-represented in

government, to secure a place for themselves in the political arena; and the identity crisis and the search for roots in a world dominated by commercialism and materialism, and in settings where rapid demographic growth combined with poverty and unemployment to produce a sense of hopelessness. All those factors were intensified by economic problems and political demands. The decline in oil prices led to significant job cutbacks in oil-producing countries, falling remittances and the return home of migrant workers to dire economic conditions. Most governments, strapped for cash, embarked on austerity policies, which had the dual consequences of increasing discontent and providing Islamic movements with the opportunity to fill a vacuum. Schools and hospitals, along with a host of welfare services, were increasingly run by Islamist groups. Islam had also become, if not the language of protest, at the very least a means by which opposition could be expressed with minimal government interference.[72] Insofar as the phenomenon is multifaceted, every one of those explanations is to some degree plausible. Taken together, they explain why different groups and social classes found reasons to embrace – or return to – Islam.

Beyond the diversity of Islams (pietist or political, modernist or revivalist, quietist or activist, moderate or radical, conservative or revolutionary, pro-Western or anti-Western), there has been virtually everywhere some demand for enhancing the role of religion in political and economic life. A diverse group of countries – including secularly oriented ones such as Egypt and Yemen – have responded by upgrading the role of the Shariah in the Constitution. A standard, if usually vague, demand by Islamist groups everywhere is to Islamicize the financial system, or at the very least to allow for Islamic financial products. So typically, as banking laws are being overhauled, some provision is made to permit, if not promote, some form of Islamic finance. It is also common both for countries exposed to Islamic challenges and for newly formed or newly independent Muslim countries to announce financial Islamicization. Soon after the 1991 Gulf War, one of the first decisions of the returning Kuwaiti government was to form a committee to study changes to the constitution in order to make the Shariah 'the sole source of legislation' (rather than simply 'a main source'). A key provision was to propose an Islamic banking legislation (at the time, the Kuwait Finance House was the sole Islamic bank in the country).[73] And in the Philippines, barely six weeks after the government had signed the 1996 peace agreement with the Islamic rebels, five Islamic banks had requested permission to establish branches in the southern part of the country where a majority of the five million Muslims live.[74] Similarly, soon after Chechnya proclaimed its independence from the Russian Federation, one of the first announcements by the president of the breakaway republic was that the financial system would be Islamicized.[75]

In sum, at a time of Islamic reawakening, the toleration, if not the

promotion, of Islamic finance is for most governments a low-cost, low-risk (insofar as the details of legislation are left for experts to work out) proposition.

5.2.4 The Concern with Ethics

Morality and ethics have always been the Achilles' heel of the market economy. Just as free-market ideas and policies triumph, there is a renewed interest in ethical matters. So there is no real contradiction: the greater the triumph of the free market, the more vocal the challenge to the 'entrenched utilitarian, rationalistic, individualistic, neo-classical paradigm which is applied not merely to the economy but also, increasingly to the full array of social relations, from crion to family'.[76]

Until recently, the imperfections and the excesses of the market were addressed by law and public policy. In the US financial system the rigour of the marketplace was mitigated by strict regulation and by legislation such as the Community Reinvestment Act, the Fair Housing Act or the Equal Credit Opportunity Act.[77] Such laws required, among other things, financial institutions to go beyond considerations of profit maximization to achieve other societal goals and ensure the provision of credit to underserved neighbourhoods and groups. In recent years, many of these strictures have been relaxed. The trend towards deregulation (since 1980) has been accompanied by a search for non-legislative and non-regulatory correctives, ranging from moral suasion to the promotion of personal ethical behaviour.[78]

Examples of the renewed interest in the ethical dimension of business and finance in an era of unfettered capitalism are numerous.[79] Ethics is now a fixture of business school curricula. Companies play up their philanthropic effort and their 'social responsibility'. 'Socially responsible' funds are booming.[80] Individualism or materialism have come under attack, and ideas about 'communitarianism', 'civic virtues', 'meaning', 'corporate citizenship' and 'stakeholding'[81] have been widely promoted, by intellectuals and also by political figures, including Bill Clinton and Tony Blair. The underlying theme is that rights cannot exist in the absence of corresponding obligations, and that aggressive individualism is not a sustainable basis for any society. Individuals are called on to give their time and effort to their communities. Corporations are called on to acknowledge a wider range of responsibilities than the maximization of shareholder value.[82]

In 1997, the Philadelphia 'Summit for the Future of America' was a major media event: under the chairmanship of General Colin Powell, and in the presence of Bill Clinton and former presidents Bush, Carter and Ford, the summit emphasized the importance of volunteering, civic virtue, and community involvement as necessary to the proper functioning of a

free-market economy.[83] In such a context, religion can be an essential part of the 'matrix of culture and the institutional structures that provide a context for personal behavior'.[84] As illustrated by the slogan 'doing well by doing good', ethical behaviour can be compatible with a market economy. In the quest for a free-enterprise system that is circumscribed by moral norms and codes, religion, and Islam in particular – a religion that holds a positive view of economic activities while providing for a strict ethical framework – can play a central role.

5.3 Embeddedness, Convergence and Fusion

This chapter and the previous one have sought to show that, the rhetoric and certain analyses notwithstanding, Islamic finance is firmly embedded within the international political and economic order. The world of banking and finance is by nature status quo oriented. It craves stability and abhors uncertainty. In every new market they have penetrated, Islamic banks have typically established links with the local power structure, have operated within the political, economic and regulatory framework, and have worked within established oligopolies.[85] At the international level, the major Islamic banking groups, rather than trying to establish a global Islamic network that would rival the global banking system, are keen on remaining embedded within that system. Indeed, in its transnational operations, Islamic banking operates more out of London, Geneva or the Bahamas, than it does out of Jeddah, Karachi or Cairo. As for the Islamic Development Bank (IBD), its statutes provide for coordination and collaboration with the International Monetary Fund (IMF) and other international organizations.[86]

In the 1970s, and as summarized by Anwar Sadat, there was a 'commonality of interests between the Islamic states and the West: oil in exchange for technology and the common interest against the Soviet threat'.[87] Ideologically, both liberalism and economic Islam were driven by their common opposition to socialism and economic *dirigisme*.[88] With the elimination of the Soviet threat, a New World Order has emerged, and with the exception of a few 'rogue' states which remained at the fringes of that system,[89] most countries involved in the second aggiornamento were active participants in, and in some cases major beneficiaries of, the new system.[90] The seminal event of the New World Order was the 1991 Gulf War, and most Islamic states were part of the US-led coalition.

Geopolitical factors were reinforced by economic and business considerations. After the oil shocks of the 1970s, the 'recycling' of petrodollars was undertaken by Western, and primarily American, banks. More generally, many countries involved in Islamic finance – especially those in the Persian Gulf – belong in the 'coupon-clipper' category and have a stake in the stability of international markets, in which they are

heavily invested.[91] Paradoxically, the paucity of acceptable Islamic products has also led Islamic banks to be heavily invested in foreign currencies and to have a large percentage of their deposits abroad.[92]

The international banking system was also instrumental in the very creation of Islamic banks. The fledgling Islamic banks, lacking experience and resources, had little choice but to rely on the expertise of their international counterparts. And as Islamic banks gained experience, the world of finance was undergoing major transformations. So rather than being phased out, the cooperation with Western banks – in the form of joint ventures, management agreements, technical cooperation and correspondent banking – was stepped up, leading to increased convergence and fusion between conventional and Islamic finance.

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6

COUNTRY DIFFERENCES

In the 70-odd countries that allow them, there are infinite variations in the importance, status and characteristics of Islamic financial institutions. Their role in national economies range from essential to insignificant. Their 'special character' may or may not be recognized. In some countries they are strongly encouraged by the authorities; in others they are barely tolerated. One of the themes running through this book is the diversity of Islamic finance. Even those countries that fully Islamicized their financial systems – Pakistan, Iran, the Sudan – did so under different religious, political, economic and cultural circumstances. In most cases, Islamicization did not occur in a carefully thought-out application of Islamic principles and jurisprudence, but in an ad hoc manner and as a result of situational factors.

This chapter discusses the experience of countries that have undergone full Islamicization of their financial systems. It also examines the case of Malaysia, a country that has promoted Islamic finance alongside conventional banking, and looks at Islamic offshore banking, with a special focus on Bahrain.

6.1 Pioneers of Full Islamicization: Pakistan, Iran and the Sudan

6.1.1 Pakistan

The Pakistani experiment in Islamic banking is nothing short of contradictory. As early as the 1950s, Pakistani economists had pioneered the study of Islamic banking. And Pakistan was the first country to embark, in 1979, on a programme of full Islamicization of its economy and financial system. The Pakistani government went farther than most Islamic governments in recreating the concepts, language and institutions of early Islam. This commitment has been constantly reaffirmed since, with countless measures designed to achieve that goal. Indeed, Islamic banking is on the platform of every major political party, and for any politician, not endorsing it amounts to political suicide.[1] Yet almost 20 years after the

Islamicization had begun, a leading Pakistani economist could state: 'I don't think in the next few years [Islamicization] is going to happen. The roots of the British banking system are very strong.'[2]

The Pakistani case, pioneering as it is, is testament to the fact that situational factors can thwart the best intentions of governments. Turmoil, poverty and indebtedness have imposed sharp constraints on policy options. The British legacy had also created commercial habits and a financial culture that could not be undone by reform. In addition to being interest-bearing, the heavy foreign debt – some $32 billion in 1998 – meant that the IMF and other foreign creditors had a say in how the economy was managed.[3]

Pakistan is a young country. Even the idea of a separate state for Indian Muslims is relatively recent. For decades, there had been a common Hindu–Muslim independence movement sparked by anti-British sentiment. But in 1930, Muhammad Iqbal (1875–1935), the poet and major figure of Islamic reform, started calling for a Muslim homeland. And since 1940, Muhammad Ali Jinnah (1876–1948), the thoroughly Westernized leader of Indian Muslims, and his Muslim League Party championed the cause of Muslim nationalism. In 1947, the British departed, India was partitioned, and the independent state of Pakistan was born. Pakistan thus constituted both a rejection of a multiconfessional, secular India and an attempt to recreate an Islamic order after a long period of Western colonial rule. The country's name was both an acronym of some of the regions that were carved out of India to create the new state, and a word in Urdu, Pakistan's principal language, that meant 'land of the pure'. The founding fathers were secular, Westernized people who were nonetheless intent on creating an Islamic state.

The task was complicated by the huge problems facing the new state: the population transfers and civil strife that followed the partition, the consistently troubled relations with India with whom Pakistan fought three wars, etc. In addition, there was still a well-entrenched British influence and a lack of consensus about the kind of Islam that should be adopted. For not only does Pakistan have a substantial Shia community (accounting for 20 per cent of the population), but even the Sunni majority (75 per cent) is divided among three major sects and dozens of amorphous groups, making a consensus on the interpretation of Islam nearly impossible.

Still, all the successive leaders of the country have reaffirmed the Islamic character of Pakistan, and their desire to harness Islam to the goals of economic growth and modernization. In 1949, the Constituent Assembly defined Pakistan as a state where 'the Muslims shall be enabled to order their lives in the individual and collective spheres in accord with the teachings and requirements of Islam as set out in the Holy Quran and the Sunna'. It declared that 'sovereignty over the entire universe belongs to God Almighty alone' and that therefore authority would be exercised by

the people of Pakistan only 'within the limits prescribed by Him'. The new country was an 'Islamic Republic', that would build itself a capital city called Islamabad.

At times, leaders felt stifled by traditional religious interpretations. Thus Mohammed Ayub Khan, who came to power in 1958, set out to 'liberate the spirit of religion from the cobwebs of superstition and stagnation which surround it and move forward under the forces of modern science and knowledge'. He once stated: 'The miracle of Islam was that it destroyed idolatry, and the tragedy of Muslims has been that they rendered religion into the form of an idol'.[4]

Throughout the 1970s, Pakistan drew closer to the Islamic world, and particularly to Saudi Arabia.[5] Interestingly, most of these developments occurred under the rule of Prime Minister Zulficar Ali Bhutto, whose name is usually associated with socialism and secularism, but who nonetheless made increasing use of Islamic language and symbolism. The country received significant amounts of aid – in addition to growing labour remittances – from oil-producing countries, and became one of the most active members of the OIC (Organization of the Islamic Conference). In 1977, the military, led by Zia ul-Haq, seized power with the support of Jamaat-i Islami, the country's best-organized and strongest religious party. In a televised address to the nation on the day of the coup, the new leader, who remained in power until his death in 1988 in a mysterious plane crash, praised the 'spirit of Islam' that had inspired the opposition to the Bhutto regime, concluding: 'It proves that Pakistan, which was created in the name of Islam, will continue to survive only if it sticks to Islam. That is why I consider the introduction of an Islamic system as an essential prerequisite for the country'.[6]

In 1979, Zia appointed a 12-member committee of 'scholars, jurists, ulema, and prominent persons from other walks of life' to formulate recommendations for the structure of an Islamic government system.[7] The recommendations included the creation of a new Islamic economic order, the substitution of traditional Islamic laws and punishments for inherited Western codes, and the creation of a pure Islamic form of government designed to serve as a model for other Muslim states.

The first phase of economic reform (1979–85) had three significant components. The zakat (almsgiving) – a 2.5 per cent percent per annum levy on savings accounts, various kinds of bank deposits, unit trusts, government securities, corporate shares and debentures, annuities, life insurance and other comparable assets – would be distributed through an elaborate voluntary system of zakat committees at federal, state, and village levels. They in turn would channel the money collected to benefit the 'mustahaqueen' (the deserving), or those living below the poverty line. The ushr (literally, tithe) would be imposed at a rate of five per cent on all agricultural produce above a certain level. The hope at the time was that it

would raise enough revenue to allow abolition of income tax and to reduce the corporate tax, thereby releasing pent-up entrepreneurial energies to the benefit of the country's economic development. The third component was the partial Islamicization of the banking system through the introduction of private-and-loss sharing (PLS) accounts. In theory, it meant that deposits would be invested by lending institutions in a productive business. If the investment turned out to be profitable, then the depositor would share in the proceeds. If it posted a loss, he would receive no return, although the original deposit would not be affected.

Such measures did not go without political controversy. The introduction of zakat caused an outcry among Pakistan's Shia minority, who objected to its being collected and distributed through the state, as opposed to through their own ulemas. Following riots in Islamabad, the government gave ground, allowing Shia groups to collect and distribute the zakat on their own. Overall, there was scepticism that the new Islamic taxes would truly alleviate poverty, or that the creation of profit-and-loss sharing windows, opened in all 7,000 branches of domestic banks, would create a qualitatively different banking system (a 'profit and loss sharing project' instead of a fixed-predetermined interest), or that it would draw the amounts hoarded by pious (or suspicious) peasants into the banking system.

Pakistan was also the first country to revive the old Islamic institution of hisbah, the office that supervised markets, provided municipal services and settled petty disputes. But in its new incarnation, the office had the much more limited role of protecting ordinary citizens against administrative wrongs.[8]

In December 1984, the Pakistani government called on all five nationalized Pakistani banks and 17 foreign banks operating in the country to submit proposals of more 'godly and brotherly' ways to generate profits. In the second phase of Islamicization, which was implemented through a series of measures imposed between January and July of 1985, interest was outlawed. In reality however, huge loopholes remained, and the successive governments, despite their official commitment to interest-free banking, proved quite pragmatic in their actions. Foreign currency deposits, foreign loans and government debt continued to function on the basis of interest. Overall, the Pakistani authorities took care to ensure that the new modes of financing did not upset the basic functioning and structure of the banking system. As a result, the exceptions proved more significant than the rule: the (interest-bearing) government debt was four times larger than the private sector's debt,[9] and about 80 per cent of domestic deposits were denominated in foreign currencies, which allow interest payments, and the rest in rupees, which do not.[10]

The government has thus been caught between two sets of conflicting forces. On the one hand, religious groups as well as a large domestic constituency had been calling for Islamicization. On the other hand, however,

Pakistan carries a long tradition of conventional, interest-based banking, and has been under pressure by the IMF and other foreign creditors to privatize its banking sector and liberalize its economy. The alliance between the military, which was committed to a policy of neo-liberalism, and the main religious party had been fraught with ambiguity. In the words of one scholar:

> Aside from abstract notions about the shape and working of the ideal Islamic state, the party had little to offer in the way of suggestions for managing its machinery. Its notions about the working of Islamic dicta in economic and political operations provided Zia with no coherent plan of action. Just as the Jama'at became disappointed with the politics of Zia's regime, so the general became disillusioned with the practical relevance of the Jama'at's ideas.[11]

In 1992, the country's Federal Shariah Court ruled that interest paid or charged by banks and other financial institutions was un-Islamic. The government was given a few months to amend its financial laws accordingly, otherwise the existing laws would 'cease to have effect'. (The government appealed the decision.)[12] Still, the government maintained its theoretical commitment to the elimination of riba. In January 1998, it decided 'in principle' to eliminate riba from the economic system of the country.[13] These conflicting pressures occurred at a time when a third of the four public banks' assets were non-performing and 30 per cent of their branches were unprofitable. Most Pakistani banks were also seriously overstaffed: by some estimates, they had twice as many employees as they needed.[14]

One of the useful lessons of the Pakistani experiment concerns the ways banks, businesses and individuals responded to Islamic finance. Profit-and-loss sharing was mostly shunned by banks, where 90 per cent of transactions consisted of mark-up schemes.[15] The new system also gave rise to questions of 'Islamic moral hazard', with many Pakistani businessmen taking advantage of the new laws to reduce their outstanding debts.[16] More generally, risk aversion and preference for the short term accounted for the behaviour and demands of bankers, businessmen and depositors.[17]

A recent appeal to reduce the country's debt has illustrated the persistent preference for fixed, pre-determined remuneration of capital. In a country where only 1 per cent of the population pays income taxes, meeting foreign debt payments had been a chronic problem. In 1997, in an attempt to make interest payments on its $30 billion foreign debt, Prime Minister Nawaz Sharif established a National Debt Retirement Scheme which gave Pakistanis three ways to participate: simply giving money to the government; lending it with zero interest; or, depositing it in an account earning from 7.5 per cent to 9 per cent 'profit'. The plan was launched amidst much hoopla. Newspapers were filled with ads from companies boasting of their contributions, and Nawaz Sharif himself contributed

$250,000. Yet the result – which was short of the $2 billion expected – showed that over 75 per cent of the money had gone into the interest-bearing accounts, which meant that the government had merely traded one kind of loan for another.[18]

All the preceding explains why most analysts have concluded that the experiment failed to live up to its billing. One Islamic banking specialist criticized the belief 'that the simple statement by a Muslim government that its banking system is Islamic suffices to make it so'.[19] Others have argued that the changes introduced in Pakistani banking 'were nominal, not substantial', that the process of Islamicization 'had lost its sense of direction' or that it 'was put in reverse gear'.[20]

6.1.2 Iran

There were two distinct phases in the history of revolutionary Iran. In the early years (1979–88), three factors were decisive: first, the desire to achieve economic independence and mark a radical break with the Shah's economic policies; second, the need to resolve the ideological struggle between conflicting strands – conservative/free market on one side and populist/socialist on the other – of the coalition that brought about the revolution; and third, the need to consolidate the revolution at a time of war against Iraq. In recent years (roughly since 1989) the challenges have been different, and the economic debates centred around new issues: reconstruction and its financing, oil production and sales, and the integration of the country within the global economy. During both periods, banking issues were rather secondary, and seldom rose to the level of 'high politics'.

At the time of the Islamic revolution, it was inevitable, given Iran's history, that economic nationalism would take centre stage. Since the late nineteenth century, foreigners (initially the British and to a lesser extent the Russians, and later the Americans) had been perceived as having exploited the country to their own benefit (the tobacco and later the oil concessions being among the most visible examples) and of having exerted undue influence on Iranian politics. The circumstances of the removal of Mossadegh and the role played by the US Central Intelligence Agency (CIA) in the return of the Shah in 1953 still loomed large in the Iranian psyche. The close military and economic ties between the Shah and the United States during the years of the oil boom were a major factor in the revolution. The hostage crisis (November 1979–January 1981) and the subsequent freezing of $10 billion in Iranian assets in the US fed anti-West attitudes.

Another peculiar feature of the Iranian situation was the strong leftist leanings of one segment of the revolutionary coalition. The Communist Party (Tudeh) was a long-time opponent of the Shah, and a myriad groups

(most significantly the Mujahedeen-e Khalq) embraced left-leaning, sometimes Marxist, ideologies. One of the main actors of the revolution was Abul-Hasan Bani-Sadr, a French-educated economist, who was an aide to Khomeini in his exile and later became the first elected president of the Islamic republic (1980–81). Although associated during his short presidency with the moderate camp, his writings had a distinct Marxist flavour. Shortly before the revolution, he had written an analysis of the 'economics of towhid' (Eqtesad-e Towhidi), which fused the theological concept of towhid (the oneness of God) with a populist political–economic interpretation. Except of course for its religious component, the analysis rejoined the 'final Communist' stage predicted by some Marxist historians.[21] This was bound to provoke a clash with advocates of an Islamic Third Way, among clerics influenced by the writings of Mohammed Baqer as-Sadr,[22] and with the advocates of a more conventional 'laissez-faire' or market economy, who were primarily Western-trained economists supported by economically conservative segments of the coalition – primarily the high clergy and the Bazaar.[23] Yet given the circumstances of the revolution, it was clear that anything marking a break with the policies of the Shah's regime would prevail.

The early assertion of economic nationalism took many forms. The vast holdings of the Shah and his entourage were confiscated and taken over by Islamic foundations. Banks were nationalized. In the new Constitution, Article 77 provided that all international treaties, conventions, contracts and agreements had to be approved by the Majlis (Parliament), and Article 81 stated that 'granting of concessions to foreigners for the establishment of companies or organizations in the commercial, industrial, agricultural, mining and service fields' was strictly forbidden.[24] A reinforcing factor was the Iran–Iraq war (1980–8), which justified the centralization of economic decision-making and led to the consolidation of statist, command-economy-style allocation mechanisms: price controls, rationing of goods, quantitative regulation of imports, etc.[25]

Two contentious economic issues took centre stage and dominated the first decade of the revolution: the nationalization of foreign trade and the issue of land reform. The Revolutionary Council which was captured early on by the radical clergy introduced in April 1980 a land reform bill, designed to transfer ownership of 'temporary cultivation agricultural land' (land seized by peasants and by revolutionary organizations in the immediate aftermath of the revolution) from the owners to the cultivators actually working the land.[26] It took over six years for the majlis to approve the bill, in a controversial and contested vote. The resolution of the issue was complicated by the power structure of Iranian politics. The parliament was dominated by populists, but its decisions could be overridden by the Council of Guardians (a body of senior Islamic jurists and experts on Islamic law), who firmly believed in private property. Conflicts between the

two bodies were typically arbitrated by the Ayatollah Khomeini in his capacity as supreme ruler. The policies were all the more inconsistent and contradictory in that Khomeini's decisions tended to go back and forth between populism and liberalism.[27]

By the end of the first decade following the revolution, the Iran–Iraq war had ended (1988) and the Ayatollah Khomeini had died (1989). A number of constitutional and institutional changes occurred, transforming power relations. For example, the velayet-e Faqih position, tailor-made for Khomeini, was weakened. Ending Iran's isolation, rebuilding the infrastructure and resuming oil exports were the new priorities. The power struggle was now between the 'ideologues' who sought to preserve the orientations of the early years of the revolution, and the 'pragmatists' who sought to loosen the grip of the government and improve ties with the outside world, the US in particular.

On economic matters, the pragmatists scored a few points at a time when foreign loans and foreign investment (especially in the oil sector) were sorely needed. Article 81 which stated that all forms of foreign loans, investment and participation were forbidden was reinterpreted by the Council of Guardians to mean that 'contracts where one party is a ministry or a government agency or company and the other party is a private foreign company, are not considered international contracts and are not subject to article 77 of the constitution'.[28] Another aspect of Iran's opening to the outside world was related to the implosion of the Soviet Union. A number of ethnic groups in newly independent states of Central Asia had ethnic, linguistic or historical ties to Persia, and Iran saw all the religious, political and economic advantages that closer ties with these countries or some of their ethnic groups could bring, at a time when Russia, the United States, Turkey and Saudi Arabia were all seeking to consolidate their own positions in the region.

Financial policy reflected the broader evolution of Iranian politics. Soon after the revolution, the banking industry had been nationalized and consolidated through a vast movement of mergers. The 1983 Usury-Free Banking Act phased out over a three-year period interest-based practices. But bank policy was strictly dirigiste. The amounts of credit and foreign exchange available to banks were rationed by the main regulatory authorities, the Central Bank, as well as the Supreme Council of Banks (a body whose members include the governor of the Central Bank as well as other government officials). And since interest rates were eliminated, the profit rate became the main policy instrument: a ceiling on profit rates was imposed. But as was the case in other countries that had Islamicized their banking systems, interest-based finance was not completely eliminated. Overseas banking operations for example continued to operate on the basis of interest,[29] and, as the next paragraphs show, informal and semi-informal interest-based finance has thrived.

One of the lessons of the Iranian experiment is that certain religiously motivated reforms can give rise to even worse religious transgressions. Riba may have been eliminated in theory, but a much higher interest rate has appeared in disguised form in informal markets. The world of Iranian finance has become more speculative than it has ever been before. Fraud is rampant and seldom sanctioned. And one of the more curious elements of the official banking system is the proliferation of lotteries and randomly offered gifts (thus raising religious issues related to maysir and gharar) as a means of encouraging savings accounts.

More specifically, the tight regulatory framework was conducive to the growth of the informal sector. Some 1,300 Islamic credit funds have become essentially 'usury stores'. Under the aegis of the Bazaar, they were federated into an 'Organization of the Islamic economy', offering annual 'profit participation' rates in the 25 to 50 per cent range.[30]

The powerful foundations, which now possess the Shah's assets, function outside of any substantive governmental control. By one account, 'the ability of the Central Bank of Iran to tax the Bonyad-e Mostazafan (Foundation of the Oppressed), or to monitor its foreign-currency flows – let alone audit its activities – is close to nil'.[31] An unregulated financial market, administered by Bazaaris, has filled the gaps opened by official banking restrictions. Abuses have been common, and a number of financial scandals have been discovered.[32] The most massive fraud occurred between 1992 and 1996. Some $4 billion disappeared and the primary suspect was Morteza Rafiqdoust, younger brother of the head of the Bonyad foundation.[33]

In the 1990s, the government moved towards greater financial liberalization. Many controls were loosened, especially in relation to foreign exchange.[34] The Supreme Council of Banks, which had previously set a uniform profit rate for all banks, now allowed banks a broader margin of profit and allowed them to increase their 'fees' and the various forms of remuneration of deposits.[35] Another significant development was the establishment of 'special economic zones' in the southeastern, northern and northeastern parts of the country. Free-trade zones were set up on the islands of Kish and Qeshm, and in Chabahar in the Persian Gulf. Iran expected to attract $5 billion in foreign investment. As of early 1998, 14 foreign banks, including banks from the United States and Switzerland, have expressed interest in establishing banking subsidiaries in those free-trade zones.[36]

6.1.3 The Sudan

The largest in Africa, this country of 35 million inhabitants has in the past two decades been buffeted by political turmoil, famine and civil war. When it became independent in 1956 (it had previously been ruled as an Anglo-Egyptian condominium), the Sudan was deeply divided geographically,

religiously and politically. Straddling the Arab world and Africa, the country had a significant (estimated anywhere between 30 and 40 per cent) minority of Christians and animists, living mostly in the south. In its institutions and legal system, the British influence was pervasive. Culturally and to a large extent politically, Egypt exerted a dominant influence. Both the Communist Party and the Muslim Brothers were well entrenched.

When they seized power in 1969, Jaafar al-Nimeiri and his 'Free Officers' appeared to follow the model of the 1952 Egyptian revolution. Nimeiri looked up to Nasser and seemed poised to emulate his populist and socialist model of government. An attempted coup by the Communists in 1971 led to significant changes. Increasingly, and in a striking parallel with the evolution of neighbouring Egypt, Nimeiri turned against his leftist allies, became an ally of the United States and Saudi Arabia, and sought to improve relations with Islamist groups. Over the years, the once secular Nimeiri became increasingly religious. Some have claimed that his newfound religious zeal was genuine, and had started after he narrowly escaped death in an assassination attempt. Others have argued it was a tactical move designed to consolidate his hold on power. Regardless of the causes, his displays of piety were innumerable. He led prayers in mosques, and he seemed intent on Islamicizing all aspects of Sudanese life. The constitution of 1973 stated that 'Islamic law and custom shall be the main sources of legislation'. As part of this policy, Nimeiri appointed a committee for the 'Revision of Sudanese laws to bring them in conformity with Islamic teaching'.

In 1978 Nimeiri signed the National Reconciliation Pact, which enabled the Islamic opposition to return to public life. Islamic political parties were able to compete successfully for parliamentary seats in national elections. The Muslim Brothers became closely associated with the new government. Hassan al-Turabi, the Sorbonne-educated leader of the Brotherhood and former dean of the University of Khartoum Law School, was appointed to the post of Attorney General in 1979. Since that time, Turabi seems to have built his power base, eventually becoming the dominant figure of Sudanese politics, in part thanks to his involvement in the Faisal Islamic Bank of Sudan, which had been created in the late seventies, simultaneously with the Faisal Islamic Bank of Egypt.[37] Both countries had then extended significant exemptions and privileges to the Saudi-financed institution.[38]

The process of Islamicization culminated with the proclamation, on 8 September 1983, of an 'Islamic revolution' that would impact Sudanese politics, law, and society. These 'September laws' caught everyone by surprise. Sadiq al-Mahdi, a former prime minister and the Oxford-educated great-grandson of the Sudanese Mahdi (the Islamic revivalist reformer who had driven out the British and established an Islamic state in the Sudan in the 1880s), dismissed Nimeiri's 'Islamic' September laws as opportunism, arguing that the imposition of Islamic law was premature and unjust, since

such laws required first the creation of a more socially just society.[39] The most dramatic and controversial aspect of the legislation was the imposition of hudud (punishments such as dismemberment and death by stoning). Even Turabi, who was then in charge of revising the Sudanese laws to ensure their conformity with the Shariah, was surprised by the legislation and found the penal code too harsh, though he later embraced it.[40]

In the following months, new guidelines were enacted for banking and taxation. In December 1983, the entire banking system, including foreign banks, was Islamicized, and interest was outlawed. By one account, 'Nimeiri timed this to outflank the traditional religious and political leaders and cultivate the allegiance of the Muslim Brothers, the only political group still supporting him.'[41] The Zakat Tax Act of 1984 replaced much of the state's taxation system with Islam's alms tax: the government was empowered to levy, collect and distribute what had been a voluntary alms tithe. Other Islamic banks were created, mostly specialized by region and by sector. The specifics of Islamic banking legislation were inconsistent, since the process of Islamicization was erratic, and in a poor, isolated and heavily indebted country, careful ijtihad on banking matters was far from being a high priority.

In early 1985, a year and a half after the September laws, Nimeiri turned against the Muslim Brothers, accusing them of plotting to overthrow him, and arrested more than 200 of their leaders, including Turabi. But it was not long before he himself was overthrown. It happened in April 1985, while Nimeiri was on a visit to the United States. Elections were held in 1986, and a new government led by Sadiq al-Mahdi came to power. It suspended the application of Islamic law, and restored the criminal court system based on civil codes inspired by the British–Indian tradition. Another coup led by a coalition of military leaders and Islamists took place in June 1989. Hassan al-Bashir was the leader of the coup, but effective power was exercised by Hassan al-Turabi, now Speaker of Parliament. Once the voice of moderate Islam, Turabi grew more radical. He established close ties with Iran, leading some to speculate about the emergence of a Khartoum–Tehran axis. In 1991, the Shariah was reintroduced in all the northern provinces, where they would apply to Muslims and non-Muslims alike.

The ups and downs of Islamicization can be explained by the chaotic situation of the country, the presence of non-Muslims (who objected to the application of the Shariah and had been in rebellion against the government since the early eighties), the divided nature of Sudanese Islam (with a strong sufi tradition at odds with the more politicized and sometimes radical Islam of the National Islamic Front) and by outside influences (of Egypt, Libya, Saudi Arabia, the United States, the International Monetary Fund and the World Bank) – all against a backdrop of economic disintegration.

The same erratic patterns prevailed in the country's relations with the West. For most of his years in power, Nimeiri enjoyed close relations with the United States. But the government's violations of human rights during the civil war resulted in suspension of US aid. In 1985, during a visit to the Sudan, then-Vice President George Bush reportedly obtained four conditions in exchange for the resumption of aid: discontinuation of the hudud, dismissal of Islamic activists from the government, halting contacts with Libya and acceptance of reforms demanded by the IMF.[42] In the 1990s, the Sudan was added to the list of countries supporting terrorism, and was subjected to a US bombing in 1998 (on the grounds that the Sudanese regime had ties to Usama bin Laden).

The relations with the IMF were also marked by a familiar cycle: suspension of aid, promises of reform followed by partial reform, resumption of aid, unrest followed by a halt in the application of IMF policies, suspension of aid. In 1990, the IMF took the unusual step of declaring the Sudan non-cooperative because of its non-payment of arrearages to the Fund. In 1992, the IMF threatened to expel the Sudan from the Fund. In response, the government administered shock therapy to the economy, devaluing the Sudanese pound, lifting price controls, and ending government subsidies, including those destined to the poorest regions of the country. The main architect of the policies, Economics Minister Abdul Rahim Hamdi, formerly an Islamic banker, justified the policies by saying: 'The population accepts these hardships, because it supports Islam and us'.[43]

6.2 The Special Case of Malaysia

Two features set Malaysia apart from other countries discussed in this chapter: first, the creation of an Islamic banking system functioning alongside the conventional one; and second, the harnessing of Islam to the goal of economic growth through the embrace of high technology and finance.

Malaysia, a multicultural country of 20 million people, with 30 ethnic groups and subgroups in 13 states, has three distinct ethnic/religious communities: 61 per cent of the population are bumiputras, 30 per cent are Chinese and 9 per cent are Indian. Most Malays are Sunni Muslims, although there is also a small Shia minority. For generations, the Malaysian economy had been controlled by minority communities (Chinese and to a lesser extent Indians). Except for a small Westernized elite, the Malays, or bumiputras, literally 'sons of the land', kept to their villages and were excluded from business life. At the time of the Malaysian independence in 1957, a deal was struck whereby in exchange for citizenship for the Indians and Chinese, the bumiputras were given political supremacy. Malay became the official language, and Islam the state religion. Ever since, politics and economics have been largely structured along religious and racial lines.

Following riots in 1969, the government adopted in 1970 a New

Economic Policy (NEP) which provided a host of preferential policies for bumiputras: quotas in universities, housing, government jobs, government contracts, etc. This massive 'affirmative action' program was designed to increase the Malay share of corporate wealth from 2.4 per cent in 1970 to about 30 per cent in 1990.

By 1990, when the government undertook a review of the NEP, significant progress had occurred, although it fell short of the 30 per cent objective. According to government statistics, the country's accomplishments were many: the percentage of the population living under the poverty line dropped to around 8 per cent in 1995 from 60 per cent in 1970; literacy rates exceeded 85 per cent and life expectancy became comparable to that of developed countries. The share of wealth of the bumiputras had increased to 20 per cent and the country had achieved a remarkable economic transformation. The main architect of the transformation of Malaysia from agricultural backwater to Asian 'tiger' was Mahathir Mohammed, a physician who became Prime Minister in 1982. In addition to persevering in the giant 'affirmative action' programme designed to benefit the Malays, his grand ambition was to turn Malaysia into a rich country by the year 2020. Throughout his rule, there was no shortage of grandiose projects, such as the Multimedia Super Corridor outside the capital of Kuala Lumpur, where the twin towers of the world's tallest building symbolize the country's ambitions.[44] Until the 1997 Asian economic crisis, Malaysia was a 'model' economy, with a thriving middle class and growth rates approaching double digits.

Islam was to be a key part of the government's ambitions. In that respect, the Malaysian brand of Islam does not fit typical Western perceptions and stereotypes. It is fused with other influences (nationalism, capitalism, 'Asian values') producing a unique ideology of development.[45] Rather than being an obstacle to change, religion was to be an engine of growth and modernization and a tool to promote financial innovation. An Islamic financial system that could offer a growing array of sophisticated financial services was part and parcel of the effort to turn Kuala Lumpur into a leading regional, if not international, financial centre.[46]

The role of religion in Malaysia is a study in paradox: the system of government is secular, yet Islam is ever-present; the constitution recognizes the primary position of Islam, but it also guarantees freedom of worship for other religious groups. The dominant political party is wholly Malay and therefore Muslim. The justice system consists of civilian courts which are administered centrally, and separate Islamic courts answerable to local state authorities. The Malaysian brand of Islam is pragmatic and tolerant, yet strict traditionalists are a political force. The northeastern state of Kelantan, for example, is controlled by the Parti Islam Se Malaysia, an opposition party whose ideology is traditional if not reactionary. On a number of occasions, Shia militants were imprisoned on the grounds that

their teachings could divide society and trigger violence between sects. By most standards, the brand of Islam promoted by the government is a modernist one, although some of the most prominent political figures (such as one-time Deputy Prime Minister Anwar Ibrahim) were at one time considered 'fundamentalists'.[47]

Malaysia is a nation in a hurry, and on numerous occasions, Mahathir has shown impatience with ulemas arguing over the fine points of religion rather than putting religion at the service of developmental goals. He accused them of being dilatory, inconsistent, or too harsh.

According to Mahathir: 'Only when Islam is interpreted so as to be relevant in a world which is different from what it was 1,400 years ago can Islam be regarded as a religion for all ages'. More specifically, he objected to those who wanted to interpret the Koran too literally. For him, the tolerant, forgiving spirit of religion should be the starting point.[48] Or in the words of his one-time heir apparent (later disgraced), Anwar Ibrahim, 'In implementing Islamic principles in banking and finance, we must address substantive issues rather than be always preoccupied with terminology and semantics.'[49] A recurring theme in speeches and publications was that hard work was a form of 'jihad'.[50]

The ulemas were challenged to a new 'ijtihad': rather than be content with the imitation of existing models, they were asked to adopt a more innovative approach, exploring the wide array of Shariah concepts that had not even been tested. They were also encouraged to look at the state-of-the-art in global finance, and create corresponding Islamic products.[51] The only products to be excluded were those that went explicitly against Islamic beliefs.

A number of Islamic research centres and universities engaged in a vast effort to legitimate modern finance, and in particular to create an 'Islamic capital market' that would use specially designed interest-free bonds and other securities. The International Islamic University opened a management school. The Malaysian Institute of Islamic Understanding (IKIM) held seminars on all aspects of religion and finance. The message was that industrialization and productivity were fully compatible with piety, and that welfare in this world was fully compatible with salvation in the next.

In order to avoid bickering among rival schools of Islamic thought, Mahathir established in 1997 a National Syariyah (Shariah) Board designed to harmonize financial practices and review the compatibility of new financial products with religion. In a statement, Bank Negara Malaysia (BNM), the country's central bank, said that it would be 'the sole authoritative body to advise BNM on Syariyah issues pertaining to Islamic banking and takaful (insurance) operations'.[52] The Board was also to play a key role in establishing Malaysia's credibility as a hub for Islamic products.

The contrast with other countries is clear. Malaysia has not sought full Islamicization but has implemented a parallel system, with Islamic banks

operating alongside conventional ones. It was a two-pronged policy designed to promote Islamic finance, and to turn Kuala Lumpur both into an international Islamic finance centre and a key conventional regional finance centre that would compete with Hong Kong or Singapore. In addition, Labuan would become an International Offshore Financial Center with a focus on Islamic products. Importantly, Islamic banking was not limited to providing special or exceptional treatment to certain banks in order to placate or co-opt certain groups. Rather it was a principal tool in the country's developmental policy, and was designed to form the vanguard of financial modernization. A number of privileges, for example greater flexibility with respect to their liquid asset holdings, were given to Islamic banks.[53]

Islamic finance cannot be separated from Malaysia's New Economic Policy (NEP), from the promotion of Kuala Lumpur as a financial centre and from the effort to enhance the role of bumiputras in the economy. The first experiment in Islamic finance can be traced back to the Muslim Pilgrims Savings Corporation, which was set up in 1963 to help people save for performing haj. In 1969, it evolved into the Pilgrims Management and Fund Board, or the Tabung Haji as it is now popularly known. In 1983, Parliament passed the Islamic Banking Act, which created Bank Islam Malaysia Berhad (BIMB), a full-fledged commercial bank, controlled by the government and in which the Tabung Haji had a 12.5 per cent participation. The bank's memorandum of association stated that 'all businesses of the company will be transacted in accordance with Islamic principles, rules and practices'. The bank has been at the forefront of financial innovation. In 1985, it set up Syarikat Takaful Malaysia, which it touted as the world's first Islamic insurance company. (In reality, other Islamic insurance companies have claimed precedence.)[54] In 1990, it issued Islamic corporate bonds. The bank also introduced Islamic Acceptance Bills and an Islamic export credit refinancing facility. In 1993 Malaysia took a further pioneering step when it introduced its dual banking system. Conventional banks were allowed to offer Islamic banking services. A bank could thus have under the same roof two windows, one for conventional banking operations, the other for interest-free transactions.[55] Throughout the 1990s, the government was also very active in encouraging the creation of Islamic products ranging from insurance to bonds, introducing a secondary market for banking products, and promoting an Islamic capital market in Kuala Lumpur whose products and practices mirrored conventional capital markets. In January 1994, the Islamic Interbank Money Market (IIMM) was introduced. Islamic unit trusts (IUT), Islamic debt securities (IDS), and Islamic commercial paper were created alongside an Islamic interbank and cheque-clearing system. The introduction of indices and benchmarks – such as the RHB Islamic Index, which tracks the performance of listed companies that do not contravene Islamic principles or

the minimum benchmark for Mudaraba interbank investments, by which a bank obtains an investment from another on a trustee profit-sharing basis – were other steps taken to promote credible capital markets, which Malaysia has in recent years perceived as being its primary competitive advantage in relation to other Islamic financial centres.[56]

Malaysia encouraged its Islamic bankers to try to become global leaders by offering home mortgages and a wide array of financial services to consumers. It was the first country to introduce Islamic mortgage bonds. Since 1994, mudaraba bonds can be used to purchase housing loans from Bank Islam Malaysia Berhad (BIMB). The bonds are based on the profit-sharing principle, with the profits generated shared according to an agreed ratio.[57] One institution, Arab-Malaysian Bank, engaged in an aggressive marketing of the country's first Islamic credit card – an interest-free Visa card on which users can charge an amount equal to their deposits in the bank for a fee that is a percentage of their annual spending. The bank said it would reject payments for night clubs, massage parlours and other religiously forbidden activities.[58] Another singular characteristic of the Malaysian system is that Islamic products were geared to Muslims as well as to non-Muslims. Muslims would have the opportunity to invest according to their religious beliefs, while non-Muslims, especially the Chinese minority which controls most of the country's wealth, would have an extension of choice in money-management.[59]

Constant financial innovation was justified by the need to remain ahead of the pack. Financial products are easy to imitate, and Malaysian leaders felt that other Islamic financial centres were closing in on them.[60] But conservative scholars, mostly outside Malaysia, considered that it was going too fast, and that in its rush to grow, Malaysian finance was cutting too many corners. One of the most controversial issues was that of the dual-window strategy. Even in the definition of acceptable products, Malaysia was considered too lax.[61] For example, call warrants were deemed acceptable so long as the underlying shares were halal.[62] In other words, complex new financial instruments were given the benefit of the doubt.

Significantly, in addition to catering to non-Muslims, many Islamic institutions were also managed by non-Muslims. And among the pioneers of Islamic finance were foreign institutions such as United Kingdom-based Standard Chartered Bank. In mid-1997, at the time of the Asian financial crisis, Malaysia had 25 commercial banks, 22 finance companies and five merchant banks that offered Islamic banking services. But Islamic assets still represented only 2 per cent of total financial assets. For the year 2000, the Central Bank anticipated that the share would reach 5 per cent.[63] It is unclear how the economic crisis of 1997–8 will affect Islamic finance. The banking sector is in need of rescuing. Particularly exposed is Bank Bumiputra Malaysia, which is 100 per cent state-owned and has already been rescued twice in the last two decades.[64] Once the darling of the

international financial community, Malaysia's reputation has been tarnished since the crisis. The NEP has come to epitomize 'crony capitalism' – the systematic preference given to bumiputra companies at the expense of Chinese ones. A number of political and economic decisions – such as the arrest of his deputy Anwar Ibrahim and the imposition of capital controls – have further isolated Mahathir, casting doubt on the future of Kuala Lumpur as an international banking centre.

6.3 Offshore Islamic Centres: The Case of Bahrain

At the outset, a distinction should be established between those offshore banking centres such as the Bahamas, that are welcoming of any and all foreign banking institutions, and those financial centres within Islamic countries that aim to compete regionally by playing the Islamic banking card. In Malaysia, the Labuan offshore centre has been created to play such a role. In the Persian Gulf, the United Arab Emirates (in particular Dubai and Abu Dhabi) have stepped up their involvement in Islamic finance. Qatar under its new, modernizing, ruler has attempted to step out of its financial isolation by promoting a policy of greater integration in the regional economy and by authorizing the establishment of an offshore banking centre. But it is Bahrain that is today by far the leader in offshore Islamic banking.

Bahrain is the smallest country of the Gulf Cooperation Council, the first where oil was discovered (in 1932) and the first about to run out of oil. As part of its policy of diversification away from oil, the country rulers have been focusing on financial services. Since its establishment in 1973, the Bahrain Monetary Agency (the successor of the Bahrain Currency Board) has been promoting the country as an international financial centre. It has been encouraging major international financial institutions to use Bahrain as their regional base, by touting a number of competitive advantages: a strategic geographic location, a tax-free environment, a skilled workforce, a pragmatic economic policy, a clearly defined legal and administrative framework, a well developed infrastructure, state-of-the-art telecommunications, a convertible currency, a liberal trade regime, and the absence of restrictions on foreign exchange.

Among Bahrain's selling points to the international financial community are its financial focus and the quality of its regulatory system. Bahrain was one of the first countries outside the G10 to impose the Basle capital ratios, and Bahraini banks have maintained an average capital asset ratio in excess of 10 per cent, above the mandatory eight per cent ratio. In 1997, best practice guidelines were issued, modelled after the United Kingdom. All Bahraini banks are expected to comply with the International Accounting Standards (IAS). Locally incorporated banks are required to publish their financial statements on a quarterly basis. The Bahrain Stock

Exchange (BSE), currently capitalized at over $7 billion, is one of the most dynamic in the region, and is heavily weighted (about 75 per cent) towards financial stocks. It is open to cross-border listing of regional and international stocks, bonds, and mutual funds and financial derivatives. It has cross-listing accords with Kuwait, Oman and Jordan. Foreign investors are allowed to buy shares in five listed stocks (ABC, Bahrain International Bank, Investcorp, Bahrain Middle East Bank, and Trans Arab Investment Banks). Also, more than 370 mutual funds are authorized to market their products in and from Bahrain. As of August 1998, Bahrain had 19 onshore banks, 32 investment banks and 48 offshore banking units (OBU) (with assets of $72 billion).[65] The two largest OBUs are the Arab Banking Corp and Gulf International Bank, accounting for 48 per cent of the market. They provide financing and trade-related services to regional oil and major industrial and commercial companies, but they are prohibited from conducting onshore business.

Bahrain intends to become the primary offshore centre for Islamic banking. It already has the highest concentration of offshore Islamic financial institutions. In 1996, Citibank, soon followed by other Western banks, opened a wholly owned Islamic bank. In 1998, Saleh Kamel, head of the Al-Baraka group, one of the two major transnational Islamic banking groups, established an offshore banking unit in Bahrain to bring together his group's diverse global banking interests.[66]

The Bahrain Monetary Authority (BMA) has Shariah advisers to help with the auditing of the banks, and a new regulatory system is being worked out to take into account the special characteristics of Islamic financial products. The BMA is also developing short-term financial instruments that would provide liquidity for Islamic banks.[67]

The main weaknesses of Bahrain are its political instability and its reliance on oil money and on large wholesale deposits. Although the Shia make up a slight majority of Bahrain's 500,000 citizens, the ruling Al Khalifa family is Sunni. Parliament was dissolved over two decades ago. Since December 1994, Bahrain, which is home to the American Fifth Fleet, has been wracked by a wave of political violence that has included car bombs and political assassinations. In addition, OBUs are heavily dependent on wholesale interbank deposits from financial institutions outside the island, and capital is likely to flee – as it did at the time of the Gulf war – whenever regional tensions rise.

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7

FINANCIAL PRODUCTS AND INSTRUMENTS

Most Islamic financial institutions engage in a variety of financial operations. Besides their range of equity, trade financing and lending operations, Islamic banks worldwide also offer a wide array of wholesale and retail products including loans, partnership investments, foreign exchange transactions, fund transfers, letters of credit, securities safe-keeping, investment management and advice, and other conventional banking services. Many are also active in derivatives, fund management and insurance. On the liability side, Islamic banks offer a variety of options for depositors. Current accounts are operated on the principles of al-wadia (safekeeping) and are not remunerated. The purpose is to offer depositors safe custody for precautionary and transaction purposes.[1] Depositors are provided with cheque-books and can withdraw their funds at any time without any restrictions or conditions. No fees are normally charged. Savings accounts usually involve higher balances and a longer time commitment. While few banks promise a fixed interest, most offer some kind of remuneration, usually left to the discretion of the institution, depending on its profitability. Investment or profit-and-loss sharing (PLS) deposits linked to bank mudaraba investments are in theory though not in practice the principal instruments offered to depositors. Banks typically offer a variety of accounts – PLS Deposit Accounts, PLS Special Notice Deposit Accounts, PLS Term Deposit Accounts – with different maturities and withdrawal conditions, and often offer separate account options for the general public and for institutional investors.

Yet in the classical Islamic tradition, the only acceptable loan was the 'qard hasan' (literally, 'good loan') or interest-free loan, and the only common form of deposit was 'al-wadia' (safekeeping). Islamic bankers have been able to devise new products and instruments by updating or combining contracts that go back to classical Islam, by creating products that pose no religious objections, or by invoking custom (urf), overriding necessity (darura) or the general interest (maslaha) to justify the creation of somewhat controversial instruments.

Given the blurred boundaries of Islamic finance and the religious controversies surrounding financial instruments, a typology is useful. This

chapter classifies financial products on the basis of the issues they raise – primarily religious and financial, but also strategic, regulatory, economic, and political – in the context of the global economy.

7.1 Murabaha and Other Mark-up Schemes

'Mark-up' transactions account for 80 to 95 per cent of all investments by Islamic financial institutions.[2] The best-known mark-up instrument is the murabaha, a cost-plus contract in which a client wishing to purchase equipment or goods requests the financial provider to purchase the items and sell them to him at cost plus a declared profit. It is thus a financing-cum-sale transaction: the bank purchases the required goods directly and sells them on the basis of a fixed mark-up profit, agreeing to defer the receipt of the value of the goods (although the goods can be delivered immediately).

There are a number of variations on the basic idea of murabaha. Under bay muajjal (credit sale, or sale on a deferred-payment basis), delivery of goods is made immediately; the price agreed upon, which includes the cost plus a margin of profit to cover administrative costs, is paid by the purchaser at a given date in the future. Similarly, bay salam (advance payment or forward buying) is the sale of goods to be delivered to the purchaser at a future date, which must be determined at the time of the contract. Not widely used yet, it has great potential in certain areas, such as agricultural products. Istisna (commissioned manufacture), an agreement for processed goods and commodities, allows cash payment in advance and future delivery, or a future payment and future delivery. The lender thus has the flexibility to pre-sell to his clients for future delivery on a cash-on-delivery basis and then negotiate the purchase.[3] There are infinite variations on the basic idea of tacking on some form of remuneration, in the form of a profit mark-up, or service or management fees.

In the early years of modern Islamic banking, mark-up transactions were regarded as temporary modes of finance, used for reasons of ease and convenience and generating income while banks devised authentic risk-sharing instruments. What happened instead was that, rather than disappearing, their importance grew over time and today they account for the overwhelming majority of Islamic transactions.

There are two main criticisms of mark-up schemes. One is that, by being low-risk and short-term, they do not fulfil the mission of Islamic banking – to share risk with the borrower. The risk incurred by the bank is usually minimal, and the profit margin is determined in advance. Indeed, the purchased assets serve as a guarantee, and the bank may also require the client to offer a collateral. The combination of predetermined fixed profit and collateral ensures that the risk taken by the bank is negligible. The other criticism is that mark-up schemes mimic conventional banking but

disguise the interest through semantic games and other 'hiyal' (ruses). Indeed, from an economic – though not from a legal or regulatory – standpoint, many such transactions are comparable to interest-rate transactions: if a borrowing firm needs $100 million to buy machinery, it could borrow money at eight per cent a year to purchase it, or it could have the bank buy the machinery on its behalf, and pay the bank $108 million a year later.

The core religious question boils down to the nature of the bank's remuneration. If it is a 'lending fee' then it is akin to interest. If on the other hand it is a remuneration for the service provided, or for the risk incurred, it is acceptable. Since the deal involves two sales transactions (one involving buying or commissioning the goods from the manufacturer, the other involving selling the goods to the 'borrower'), the main difference from a conventional banking loan is that there is a period during which the financial institution owns the goods. During that time the bank bears the risk that the goods will be damaged or destroyed, or that the seller may go bankrupt, or otherwise reject the goods as unsatisfactory. Commonly however, the bank will cover itself against such possibilities, the period of ownership will be more symbolic than real (since the duration can theoretically be of just one second), and the profit of the bank will correspond roughly to the prevailing rate of interest for the period involved.

Especially problematic have been the 'synthetic' murabaha transactions involving trade financing, and widely used in London. Frank Vogel writes:

> These transactions involve, for the most part, trade financing deals between Islamic investors and well-known multinationals seeking lowest-cost working capital loans. Although these multi-billion-dollar contracts have been popular for many years, many doubt the banks truly assume possession, even constructively, of inventory, a key condition of a religiously acceptable murabaha. Without possession, these arrangements are condemned as nothing more than short-term conventional loans with a predetermined interest rate incorporated in the price at which the borrower repurchases the inventory.[4]

As a result of criticisms by Islamic scholars, a growing number of financial institutions have vowed to start phasing out certain types of murabaha transaction.[5] Others have attempted to change their pricing strategies so that the mark-up would be in proportion to the magnitude of the service rendered as opposed to the sum involved and to prevailing interest-rate benchmarks.

7.2 Leasing

Ijara or leasing is probably the fastest growing activity of Islamic financial institutions. The principle is well known and virtually identical to conventional leasing: the bank leases an asset to a third party in exchange

for a specified rent.[6] The amounts of payments are known in advance and the asset remains the property of the lessor. Only in a few respects do Islamic contracts differ. A variation on the basic principle is ijara wa iktina, a lease-purchase agreement whereby at the expiration of the lease, the lessee becomes the owner of the asset.

From the standpoint of classical Islamic fiqh, ijara is understood as the sale of usufruct (manfaa) and, as such, its rules closely follow those of ordinary sales. In order to avoid the elements of riba and gharar, there are a few (minor) differences between ijara and conventional leasing. The law views some benefits and burdens of the property as belonging naturally and unchangeably to the lessee, others to the lessor. For example, the law provides that the duty to repair the goods always fall on the lessor since the repair benefits him as the owner. Also, the usufruct is not something existent and tangible, but a stream of use extending into the future, which is risky and unstable. Islamic law thus gives broad scope to the lessee to cancel the lease if the usufruct proves less valuable than expected.[7] Finally, the price at which the asset may be sold to the lessee at the expiration of the contract cannot be predetermined.[8]

A number of reasons account for the rapid growth of leasing: it is an acceptable instrument in the eyes of most scholars; it is an efficient means of financial intermediation; by financing assets, it is a useful tool in the promotion of economic development; because it is a well-established instrument that lends itself to standardized mechanisms and procedures, and because of its similarity to conventional leasing, it is a flexible mode of financing that lends itself to securitization and secondary trading and to collaboration with conventional institutions.

Although initially directed primarily at businesses, ijara is increasingly used in retail finance, primarily for home mortgages, cars and household needs.

7.3 Profit-and-loss Sharing

The basic principle of profit-and-loss sharing is that instead of lending money at a fixed rate of return, the banker forms a partnership with the borrower, sharing in a venture's profits and losses. The partnership can be of one or two types: mudaraba (commenda partnership or finance trusteeship) and musharaka (longer-term equity-like arrangements). In both cases, the bank receives a contractual share of the profits generated by business ventures.

The principle is at the core of the Islamic banking philosophy. It is at once the most 'authentic' form of Islamic finance since it replicates transactions that were common in the early days of Islam,[9] the one that is most consistent with the value system and the moral economy of Islam, and the most 'modern' one. Indeed, venture capital and merchant banking –

both among the fastest growing segments of contemporary finance – would be conventional equivalents of profit-and-loss sharing arrangements. One of the critiques of collateral-based lending at a fixed, predetermined interest, is that it is inherently conservative. It favours the rich, and those who are already in business, and is only marginally concerned with the success of the ventures it finances. In contrast, under profit-and-loss sharing, Islamic institutions as well as their depositors link their own fate to the success of the projects they finance. The system allows a capital-poor, but promising, entrepreneur to obtain financing. The bank, being an investor, as opposed to a lender, has a stake in the long-term success of the venture. The entrepreneur, rather than being concerned with debt-servicing, can concentrate on a long-term endeavour that in turn would provide economic and social benefits to the community. Yet, disappointingly, profit-and-loss sharing constitutes only a small part (about five per cent) of the activities of Islamic banks.[10]

Under mudaraba, one party, the rabb al-mal (beneficial owner or the sleeping partner), entrusts money to the other party, called the mudarib (managing trustee), who is to utilize it in an agreed manner. After the operation is concluded, the rabb al-mal receives the principal and the pre-agreed share of the profit. The mudarib keeps for himself the remaining profits. The rabb al-mal also shares in the losses, and may be in a position of losing all his principal. Among the other rules of mudaraba are the following: the division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump sum or guaranteed return; the rabb al-mal is not liable for losses beyond the capital he has contributed; the mudarib does not share in the losses except for the loss of his time and efforts. Such a financing system was common in medieval Arabia where wealthy merchants financed the caravan trade. They would share in the profits of a successful operation, but could also lose all or part of their investment if, for example, the merchandise was stolen, lost, or sold for less than its cost. Mudaraba contracts were codified by medieval jurists and could take on extreme complexity. Different fiqh traditions have resulted in differences among the various schools. Hanafis and Hanbalis argue, for example, that the profit can be shared only when the activity is completed and the financier has been reimbursed his principal, while Malikis and Shafiis permit the distribution of the profit even before the operation is completed and the principal has been reimbursed. The mudaraba contracts also influenced other cultures. The commonly used *commandite* in French law grew out of the mudaraba contracts.

Musharaka is similar in its principle to mudaraba, except for the fact that the financier takes an equity stake in the venture. It is in effect a joint-venture agreement whereby the bank enters into a partnership with a client in which both share the equity capital, and sometimes the management, of a project or deal. Participation in a musharaka can either

be in a new project, or in an existing one. Profits are divided on a predetermined basis, and any losses shared in proportion to the capital contribution. The two methods can be combined. For example, the initial capital of a project can be financed by musharaka, while later working capital may be provided according to murabaha.

The liability of the financier is exclusively limited to the provided capital. That of the entrepreneur is restricted solely to his labour. However, if negligence, mismanagement or fraud can be proven, the entrepreneur may be financially liable. Under certain circumstances, for example if the mudarib has engaged in religiously illicit activities (speculation or the production of forbidden goods or services), or if the bank has imposed a collateral for its investment, the mudaraba or musharaka contracts can be considered null and void. Recent variations on mudaraba and musharaka are the 'diminishing' mudaraba (mudaraba mutanaqisa) and the 'diminishing' musharaka (musharaka mutanaqisa), where the bank's capital or the bank's share are progressively reimbursed, allowing the entrepreneur to progressively increase his share in the project.

Although most scholars consider profit-and-loss sharing as the most authentic and most promising form of Islamic contracts, there are a few dissenting voices. Objections fall into two categories: it is a medieval contract, that is not necessarily adapted to contemporary economic realities; and it may contravene the original meaning of riba (in the sense of lack of equivalency of counterparties) and may lead to one party taking advantage of the other, which happens if one of the participants has incomplete knowledge or a weak bargaining position. In addition, profit-and-loss sharing arrangements create managerial and regulatory problems that have yet to be fully mastered. For example, the mudarib can ask for more money than he needs, or he can engage in high-risk endeavours, knowing that he will not be committing his own money. The bank can also take advantage of a mudarib who is pressed for cash, or of depositors who know little about the deal. It can also structure the transaction so as to transfer the risk to the other participants.[11] To avoid such abuses, bankers are expected to exert due diligence, and all operations must be characterized by transparency. The mudarib must prove that he is reputable and experienced, and that he enjoys high moral standing within the business community. The project must be viable and assessed independently by the bank or by external consultants. The bank must ensure that its funds are properly spent, and that the venture being financed is properly monitored.[12]

To finance such arrangements, most Islamic banks offer accounts that act like investment funds. Depositors can reap profits from a venture's success, but risk losing money if investments perform poorly.[13] Investment accounts also differ from savings accounts in that they usually require a higher minimum amount, and a longer duration of deposits. Many institutions also offer special investment accounts, which are linked to

specific ventures. These are usually reserved for institutional investors or high net-worth individuals.

The return paid on investment accounts is determined by the yield obtained from all financial activities of the bank. After deducting such administration costs as wages, provision, and capital depreciation, the bank pools the yields obtained from all ventures, and the depositors, as a group, share the net profits with the bank, according to a predetermined ratio that cannot be modified for the duration of the contract. Different banks have different policies concerning the calculation and disbursement of profits. Some do it monthly, others quarterly, others still semi-annually or even annually.

Perhaps the greatest strategic challenge of Islamic financial institutions is to increase their involvement in PLS activities and overcome the institutional and cultural obstacles that have so far stood in the way.[14]

7.4 Stocks, Bonds, Commodities and Foreign Currencies

On the matter of investments in international markets, important changes have taken place between the first and the second aggiornamento. In the early days of Islamic finance, financial markets had yet to undergo their revolution. Equity markets, as illustrated by the sharp drop in the Dow Jones Industrial Average in 1974–5, were bearish. Commodity markets, led by oil, were in contrast bullish. Generalized floating currencies offered new opportunities for foreign exchange operations.

The early doctrine could be summarized as follows: trading in commodities markets was encouraged, since the buying and selling of 'real goods' was involved; foreign exchange trading, by analogy with early Islamic dealings in gold and silver, was permitted; bonds, whether corporate or governmental, were frowned upon since they involved interest. As for equities, legal scholars were divided. For some, equity investment was based on the principle of profit-and-loss sharing, since investors linked their financial future to that of the companies they invested in. For others, equities were not acceptable because many companies earned all or part of their income from illicit activities (banks rely on interest income; hotels, restaurants or airlines usually sell liquor; etc.). Even more significantly, most Western companies pay interest on borrowings and earn interest on their cash deposits.

Another principle of the early days of modern Islamic finance was that investments, whether in equities or commodities, could not be bought for short periods solely to make a profit. Placements had to be for the long term and for the purpose of promoting investment.[15] By the 1980s and especially by the 1990s, Islamic financial institutions had changed their outlook as a result of the dramatic changes in the international environment, and of their own experiences. Many leading Islamic banks had lost

considerable amounts on foreign exchange and commodities markets. Most of these investments were all the more controversial because they were essentially short-term and speculative, and had no developmental or community-related purpose. At the same time, with deregulation, more and more products were on the market. New types of bonds – such as zero-coupon bonds – could be riba-free. This proliferation of products favoured a case-by-case approach. Also, Shariah Boards became more inclined to adopt a pragmatic approach towards equity investment. The Al-Baraka group led the way in trading stock in Western firms.[16] Shares of indebted companies could be bought if the indebtedness was low (30 per cent of total funding is acceptable for many Shariah Boards.)[17] Also, profits could be 'purified' (that is, the share of profits derived from illicit activities could be given to charity). As for many of the new 'hybrid' products (for example, debt-equity swaps created in the wake of the Latin American debt crisis),[18] they were often considered acceptable by Shariah Boards.

7.5 Derivatives and New Financial Products

While options, swaps and futures have existed for some time, the word derivatives only entered the financial vocabulary in the late 1980s. It refers to financial products whose value is 'derived' from an underlying asset. Most derivatives were originally created as 'hedging' devices, or ways of controlling or reducing risks generated by fluctuating interest rates or currencies. By another definition, derivatives are 'bets on interest rates, currencies and commodities that result in real cash obligations or rewards'.[19] These different perspectives suggest the potential as well as the risks, religious and otherwise, involved in such new products. Since the explosion of the derivatives markets is a recent phenomenon, most scholars don't quite know what to make of a wide array of recently created products. Especially troublesome are those 'exotic' derivatives – often a euphemism for complicated products of dubious economic value devised by clever 'financial engineers'.

On the positive side, derivatives can play an important role in risk management. Also, financial innovation can be a good thing for Islamic finance, since by being 'sliced and diced', financial products can be tailored to the needs of religious-minded investors. Objectionable features can then be removed from a product. A bond issue, for example, can be divided into 'interest-only' or 'principal-only' components. The 'principal-only' component, just like zero-coupon bonds, can satisfy clients who do not want to deal directly with interest.

The flip side is that the element of volatility and the potential for gharar are greatly increased. Although riba-qua-interest is not directly involved, derivatives raise other riba-related issues. Indeed, riba in its original meaning is the 'unlawful gain derived from the quantitative inequality of

the counter-values in any transaction purporting to effect the exchange of two or more species (anwa', singular naw'), which belong to the same genus (jins) and are governed by the same efficient cause ('illa, plural ilal)'.[20] Even more significantly, derivatives contain a strong element of gharar (uncertainty), and raise a host of moral and ethical issues, such as taking advantage of want of knowledge (jahl), and fraud (ghosh). The Long-Term Capital Management (LTCM) losses, the Orange County bankruptcy, the Procter and Gamble lawsuit against Bankers Trust, and the collapse of Barings illustrate the dangers of derivatives.[21]

Islamic scholars and banks must navigate amidst those contradictory features of derivatives. A number of efforts have been undertaken to identify those derivatives that would be Islamically acceptable, and revise earlier approaches to financial innovation. In the early years of Islamic finance, forward and option transactions were not allowed.[22] In recent years, religious experts have adopted a more tolerant view, noting that a number of accepted Islamic contracts such as salam (where a buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price) are not fundamentally different from futures or forwards. So is istisna, which permits the deferral of delivery and payment of processed commodities. But there are subtle nuances. In the words of Frank Vogel:

> Hadiths permit a salam contract in which one pays a year in advance for so many bushels of wheat at harvest time – certainly a risky transaction as to price. But they also forbid a salam contract tied to the crop of a particular tree or field.[23]

But when it comes to 'inverse floaters', 'kitchen sink bonds' and other very complex financial instruments, qiyas (analogical reasoning) cannot be very useful. In a world where derivatives can be so complicated that they are barely understood even by people who create and sell them,[24] medieval fiqh is of little help. Classical scholars had gone to great lengths to define conditions of valid contracts. Tomes were written analyzing issues of existence, deliverability, precise determination of the goods exchanged, of likeness, genera, fungibility, etc. Great care was given to such things as weighing and measuring the products, assessing their defects and physical changes, and to such matters as physical exchange, as well as when and where financial obligations were to be settled. A number of pre-Islamic contracts were forbidden because of the element of uncertainty: muzabana (exchange of fresh fruit for dry fruit); muhaqalah (the sale of unharvested grains in exchange for an equal quantity of harvested grains); mulamasah (a sales contract in which the sale was finalized with the buyer or seller touching a piece of cloth); munabudhah (a sales contract in which the sale was finalized with the buyer or seller throwing a piece of cloth towards the other).[25] The problem of these contracts, and of most classical analogies

that go back to medieval times – a fruit that has not yet ripened, a pregnant camel, a bird in the air, a fish in the water – is that they are of little relevance in an era of electronic settlements, e-cash and 24-hour trading.

Yet some of the Islamic prohibitions clearly strike at the heart of financial innovation. Michael Lewis, in his account of his experience at Salomon Brothers, wrote in reference to mortgage-based derivatives:

> Risk could be canned and sold like tomatoes. Different investors place different prices on risk. If you are able, as it were, to buy risk from one investor cheaply and sell it to another investor dearly, you can make money without taking any risk yourself. And this is what we did.[26]

The sale and transfer of risk is precisely at the centre of the prohibition against gharar. What makes the evaluation of such transactions all the more tricky is that the use of language can be deceiving. Lewis also wrote:

> In need of a euphemism for what we did with other people's money, we called it arbitrage, which was just plain obfuscation. *Arbitrage* means 'trading risklessly for profit'. Our investors always took risk; *high-wire act* would have been more accurate than *arbitrage*.[27]

Financial innovation is also all about the subdivision of financial instruments and the creation of equivalencies of debts and other instruments where none existed before. Yet classical fiqh frowns upon such things as settling a debt with another debt as well as on various forms of financial creativity. Various Hadiths attributed to the Prophet injunction against combining a sale and a stipulation (bay wa shart), against combining two bargains in one, or against the sale of a delayed obligation for a delayed obligation.[28]

Given the economic necessity of certain types of derivatives, Islamic scholars are bound to adopt a modernist approach that bypasses medieval fiqh and focuses on a clear understanding both of the spirit of Islam and of the actual contents of the new derivatives. At the same time, scholars must use caution in not going all out in embracing all financial innovations, as most are fraught with serious ethical, not to mention financial, flaws.

7.6 Islamic Mutual Funds

At the time of the first aggiornamento, mutual funds were little known in the Islamic world. It should be no surprise that the early literature makes little if any reference to them. In recent years, they have become a preferred vehicle for saving and investment. The principle of professionally managed funds is simple: investors pool their resources to invest in certain types of instruments (currencies, commodities, bonds, and most commonly, stocks). Funds are professionally managed and allow for considerable

flexibility. They offer a broad choice of products, and can accommodate a variety of fee arrangements and risk, maturity and fiscal preferences.

Recent years have seen a boom in socially responsible investing. Many funds have avoided certain categories of companies – for example, those with questionable labour or environmental practices, or those that did business in South Africa when that country practised apartheid. Similarly, it has long been common for religious groups to invest according to their beliefs. The New York-based Interfaith Center for Corporate Responsibility, for example, is a social-investing coalition of 275 Protestant, Catholic and Jewish institutional investors.[29]

Islamic investment funds are similar to socially responsible mutual funds in that they select their placements not on the basis of profitability alone but on non-economic criteria – in this case, compatibility with Islamic values. Driven by the abundant liquidity and the boom in financial markets, thousands of investments funds were started in recent years. In addition to Islamic financial institutions, virtually every major Western financial institution – such as Merrill Lynch, Goldman Sachs, Flemings, etc. – now offers Islamic investment funds.

While most funds stay away from highly speculative investments or from industries – gambling, alcohol, pork – that are strictly haram (forbidden), areas of controversy persist. Some stay away from interest-paying bonds (although zero-coupon bonds are usually deemed acceptable), conventional banking stocks, and heavily indebted firms. As for conglomerates and companies that derive only a small portion of their earnings from un-Islamic activities (for example, airlines that serve alcohol), or indices or market proxies that include 'un-Islamic' securities, certain funds shun them altogether, while others engage in a 'purification' process: the share of revenues from unacceptable activities is deducted and donated to charity.[30] Many funds have adopted the 30 per cent rule: it is acceptable to invest in a company that derives less than 30 per cent of its income from haram activities and whose indebtedness level is below 30 per cent.[31] To resolve such controversies and guide their investments, many funds have Shariah board or Shariah advisers.

In 1999, Dow Jones and Company has created the Dow Jones Islamic Market Index or DJIM, which tracks 600 companies (from within as well as from outside the Islamic world) whose products and services do not violate Islamic law. The index excludes companies involved in alcohol, pork, tobacco and weapons; firms in the entertainment business (such as hotels, casinos and cinemas); and those in conventional financial-services industry. The index also screens out companies with unacceptable financial ratios, such as high debt levels. In addition to pre-screening companies – assuring institutions and individuals that their investments don't transgress religious law – the index provides a yardstick against which investors can measure the performance of existing Islamic mutual funds.[32]

7.7 Development Banking

Development is still the great unfulfilled ambition of Islamic banks. For reasons discussed elsewhere, banks have been focusing primarily on short-term, trade-oriented transactions that offer a combination of low risk and profitability.[33] One recent trend has been participation in large financing projects. The muqarada technique in particular allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqarada bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.

At the centre of development banking is the Islamic Development Bank (IDB or IsDB). The idea was first discussed at the Second Islamic Finance Ministers' Conference, which was held in Jeddah on 10 August 1974. The bank, whose membership is open to all of members of the Organization of the Islamic Conference (OIC), started its operations in 1975. It now has 51 members.[34]

The stated objectives of the bank as set out in its 1981 Articles of Agreement are: to foster the well-being of the people of Muslim countries; to achieve a harmonious and balanced development on the basis of Islamic principles and ideals; to meet the need for mutual financial and economic cooperation among the Muslim states; to meet the need to mobilize financial and other resources both from within and outside the member countries; and to promote domestic savings and investment and a greater flow of development funds into member countries.[35]

As with private Islamic banks, the stated goal of emphasizing profit-and-loss sharing agreements has met with early disappointment. Its main activities are export financing, leasing, and interest-free loans. The bank also provides technical assistance, promotes technical cooperation, and assumes a wide range of developmental roles.[36] Among the schemes promoted by the bank are the Import Trade Financing Operations (ITFO), the Islamic Banks' Portfolio (IBP), the Longer-Term Trade Financing Scheme (LTTFS), and the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), which provides export credit insurance or reinsurance against commercial and political risks.

The bank's initial capital was two billion Islamic dinars (Islamic dinars are equal to the Special Drawing Rights of the International Monetary Fund). In 1992, it was increased to six billion Islamic dinars. In order to supplement its capital resources, the bank introduced schemes such as the Investment Deposit Scheme, the Islamic Banks' Portfolio (IBP) and the Unit Investment Fund (UIF) to mobilize resources from the private sector. The bank maintains a Special Assistance Account, which is utilized to assist member countries afflicted by natural calamities and to finance health and

educational projects aimed at improving the socio-economic conditions of Muslim communities in non-member countries. The bank also established the Islamic Research and Training Institute (IRTI), which became operational in 1983. The IRTI undertakes research, conducts training, publishes studies, and organizes conferences on Islamic economics and banking and in related areas.

In 1998, the bank extended soft loans, or put together 'economic rescue packages' involving other Islamic or regional banks, for financially strapped countries, in particular Pakistan (following sanctions related to its nuclear policy) and Indonesia (which was badly hit by the Asian financial crisis of 1997). The bank is also evolving into a sort of lender of last resort for Islamic banks and governments.

The Saudi Arabian Monetary Agency (SAMA) acts as the depository institution for IDB funds. One occasional source of controversy has been the fact that those funds were receiving interest – in fact becoming the main source of profits for the bank.[37] The bank's charter expressly permits it to invest excess funds 'in an appropriate manner', and the criterion of overriding necessity (of development in the Islamic world), in addition to the lack of suitable investments has been repeatedly used to defend that policy.[38]

Most assessments of the institution have emphasized a dynamism that is seldom encountered among development banks.[39] Given the number of member countries, inevitable disagreements have occasionally arisen over politics, priorities and appropriate geographic focus. Following the signing of the Camp David Agreements in 1979, IDB assistance to Egypt was suspended. Interestingly, there has been no favouritism towards Islamist regimes. One analyst noted: 'Much Islamic Development Bank funding has gone to Turkey in recent years, hardly the most needy state in the region, but one that has consistently been able to identify sound and worthwile projects requiring funding'.[40] At the same time, relations with the Sudan were strained because 'some of the self-professed Muslim governments in Khartoum have not been to the liking of the Islamic Development Bank'. Among the most recent recipients of substantial aid are the new Central Asian states of the former Soviet Union.[41]

7.8 Zakat-related Products, Instruments and Practices

Zakat (literally, 'purification') has been regarded throughout Islamic history as the principal welfare system – a means of taking care of the needy in society, and of achieving some measure of income redistribution.[42] Zakat, or almsgiving, is one of the five pillars, or duties, of the Islamic faith.[43] The proper recipients of zakat funds are specified in the Koran: the poor and the needy, zakat collectors, travellers in difficulty, and captives (9:60).[44] Although in theory consisting in voluntary almsgiving, it could be

assimilated to a religious tax. Early Islam established elaborate rules as to amounts, collection practices, exemptions and the like. Every Muslim possessing a certain amount of resources was expected to contribute. Zakat was to be levied on traded goods and revenues from agriculture and business transactions, but not on personal property or belongings. Different rates (from 2.5 to 10 per cent) applied to different categories of products (produce, livestock, etc.). Although often regarded as a fixed, unchanging system, the zakat system has evolved since the early days of Islam according to the Islamic community's revenue and welfare needs. [45] A few scholars have placed far more emphasis on zakat than, say, on riba. For such scholars, zakat is quite simply the cornerstone of Islamic economics.[46]

In the contemporary setting, there have been debates about the nature, relevance and usefulness of zakat: should it be voluntary or compulsory? Should it be fused with the official tax system or kept separate? What items should be imposed and at what rates, or should the categories and rates of early Islamic days be kept unchanged? Should individuals give their contributions directly to a beneficiary or else to a special institution set up to distribute the funds? As more countries Islamicize their economies, governments have tended to reintroduce zakat as a cornerstone of both the tax and the welfare systems. In Pakistan for example, rules about zakat are established and enforced by the government.[47]

Since the first aggiornamento, zakat has been a part of modern Islamic finance. Indeed, most Islamic banks set aside a percentage of their profits for charitable activities, and a number of institutions specialize in grants, and interest-free and subsidized loans. Most Islamic banks are involved in zakat at two different levels. First, they are likely to contribute a percentage of their profits – over and above secular taxes – to charitable causes. Hence the frequent mention in financial statements of 'profits before taxes and zakat'. Second, many banks administer zakat funds, collecting and distributing money, often on behalf of their clients, for the needy and for a variety of charitable and welfare organizations (schools, hospitals, etc.). This can take the form of outright grants, or of qard hasan (interest-free loans given for charitable purposes). In some cases, the zakat funds are used to relieve a bank's distressed debtors.

A few Islamic banks are primarily, or even exclusively, 'social banks' as opposed to being profit-making ventures. Thus, the Nasser Social Bank, one of the first Islamic banks, created in the early 1970s as a successor of sorts to the Mit Ghamr bank,[48] initially focused on qard hasan (interest-free loans to underprivileged groups when faced with exceptional expenses arising from illness, weddings or funerals), and on financing pilgrimages to Mecca, pensions and welfare benefits. The bank also established a fund for administering social insurance. (In later years, the bank moved beyond such activities and started investing in economic projects.) Social banks raise, of course, questions of financing and regulation. The Nasser Social

Bank was initially supervised by the Ministry for Social Affairs and the Ministry of Finance, and received 2 per cent of the net profits of public enterprises to finance its services.[49]

Some Islamic banks use their own zakat contributions in a somewhat self-serving way, as a means of covering the cost of their bad loans, by extending qard hasan to their own borrowers who are experiencing financial difficulties, especially in connection with profit-and-loss sharing (PLS) transactions.[50]

7.9 Micro-lending or Micro-finance

Most micro-lending or micro-finance institutions (MFI) are not, technically, Islamic banks. Yet they may be closer to the moral economy of Islam than many self-styled Islamic banks, and will no doubt be a source of ideas and concepts for Islamic finance in the future. The micro-lending idea has gained a number of adherents, in particular among governments and international organizations in recent years. In February 1997, a micro-lending summit chaired by First Lady Hillary Clinton was held in Washington.

Micro-lending purports to provide a market-based solution to one of capitalism's thorniest problems: integrating the poor into the economy. The major difference with zakat-based schemes is that it focuses on moving people off the dole and into productive enterprise. Self-help and self-reliance are at the centre of the system. The scheme turns the conventional banking logic on its head: rather than looking for creditworthy customers and basing lending decisions on credit history and collateral, MFIs lend small amounts of money to people – principally women – with no resources, as a means of integrating them in the productive economy. The following statement about Islamic finance could have been written in connection with micro-lending:

> To establish a grass-root foundation in the society and to narrow down the rich–poor gap, Islamic banks have a moral and social responsibility towards their economies by investing in long-term projects. This means channelling resources to the people who need them, especially the womenfolk and the poor.[51]

The best-known experiment in micro-lending is Muhammed Yunus's Grameen Bank, which was initially started in Bangladesh and has since been replicated in more than 50 countries.[52] Although interest-based and devoid of any explicit references to Islam, the Grameen Bank concept – not to mention the fact that it was created in an overwhelmingly Islamic country by a Muslim – is based on a central tenet of the moral economy of Islam. (Although Grameen Bank charges interest, a number of micro-lending operations do not.)

MFIs have largely fulfilled the ideal of self-help, preservation of local traditions, and entry into the productive economy.[53] According to Jacques Gélinas: 'The MFIs are in the process of destroying several very old myths: the poor are not creditworthy; they are not reliable borrowers; they are not resourceful enough to make savings; they are bad investors and even worse entrepreneurs.'[54] Grameen Bank boasts that 98 per cent of its loans are repaid on time.[55]

The main objection of Islamic scholars to micro-lending banks is that they lend at interest. On occasion, other controversies have arisen, for example in Afghanistan, where the Talibans forced out the Grameen Bank, accusing it of 'promoting shamelessness among Afghan women' and of having encouraged its Bangladeshi customers to turn to Christianity, in addition to having caused 70,000 Bangladeshi women to divorce their husbands.[56]

7.10 Insurance

The case of insurance is testament to the ability of Islamic finance to evolve in its interpretations and practices. For years, it had been an article of faith that insurance was not compatible with Islam, because it contained elements of gharar, maysir and riba. Since it was all about uncertainty and chance occurrences, insurance looked like a catalogue of prohibited practices: inequality between premiums paid and benefits collected (or not collected) from the insurance company; premiums placed in interest-bearing instruments; late payment of premiums resulting in interest and late-fees; uncertainty over subject matter and duration of contracts; etc. Not surprisingly, and unlike other financial instruments, there is no true antecedent to insurance in classical Islam.

At the time of the first aggiornamento, traditional attitudes still prevailed. In one of the official publications of the International Association of Islamic Banks (IAIB), one could find a damning indictment of an industry pervaded by 'usury, deceit, misrewarding, gambling, and betting'.[57] Especially troublesome in the eyes of many Muslims was life insurance, perceived as gambling on matters of fate and divine will.

But in recent years, after much debate,[58] Islamic doctrine has come to terms with most forms of insurance – including life insurance. One of the objections had been to deriving profit from insurance. The early insurance operations tended to be non-profit, but today most Islamic banking groups have their insurance subsidiaries. Indeed, business insurance is increasingly seen as necessary in a modern economy, if only to tame risk and uncertainty, and thus a legitimate business occupation. Even life insurance has lost the stigma that was long attached to it. Planning on receiving money upon someone's death is no longer seen as an illicit gamble on misfortune, if not a God-defying act, but rather as a positive step designed

to ease the lives of survivors. Some modifications were however to be added to conventional insurance schemes. The central principle of Islamic insurance is that of mutual guarantee (takaful), or solidarity. Contracts have been devised that combine takaful with the principle of mudaraba. A typical example, which incorporates profit-and-loss sharing principles, would provide for premium payers to become partners in the insurance company and thus be entitled to a share in the profits and losses of the company. In most cases, insurance policies are based on 'solidarity mudaraba' schemes, which have been described in the case of life insurance as follows:

> [T]he participant in a solidarity scheme pays in a specific amount in installments between his minimum age (20 years) and the age of 60. The maximum age for participation is 55 years. The participants' principal is invested in profitable but licit ventures and the profits are re-invested. If he dies before the age of 60, his legal heirs receive the paid-up principal to date, the accumulated profits to date, and in addition the amount which the deceased would have paid in had he lived to the age of 60. This latter amount is deducted from the Mudaraba profits of all other participants in the scheme, hence the term 'solidarity'. Otherwise, the participant is paid his principal and accumulated profits at the age of 60.[59]

Notes

1. The practice of the custodial contract by which the depositor hands over to the depositary property or money to be kept and returned intact at a later date goes back to the early days of Islam. See Abraham L. Udovitch, 'Bankers without Banks: Commerce, Banking, and Society in the Islamic World of the Middle Ages', in *The Dawn of Modern Banking*, Center of Medieval and Renaissance Studies, University of California, Los Angeles, Yale University Press 1979, p. 259.
2. Saad Al-Harran (ed.), *Leading Issues in Islamic Banking and Finance*, Selangor, Malaysia: Pelanduk Publications 1995, p. xi, and Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk, and Return*, The Hague: Kluwer Law International 1998, p. 135.
3. Fuad Al-Omar and Mohammed Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges*, London: Zed Books 1996, p. 19.
4. Vogel and Hayes, p. 9.
5. Vogel and Hayes, p. 143.
6. Al-Omar and Abdel-Haq, pp. 11–19.
7. Vogel and Hayes, pp. 143–5.
8. Al-Omar and Abdel-Haq, p. 66.
9. Abraham L. Udovitch, *Partnership and Profit in Medieval Islam*, Princeton University Press 1970, pp. 170–248.
10. Al-Harran, p. xi, and Vogel and Hayes, p. 135.
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26. Michael Lewis, *Liar's Poker: Rising Through the Wreckage on Wall Street*, New York: Norton 1989, p. 187.
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28. Vogel and Hayes, p. 68.
29. *Institutional Investor*, February 1998.
30. *The Wall Street Journal Europe*, 19 September 1997 and *Financial Times*, 8 November 1996.
31. *Financial Times*, 26 April 1997.
32. *The Wall Street Journal*, 8 February 1999.
33. See chapters 8 and 9.
34. Afghanistan, Albania, Algeria, Azerbaijan, Bahrain, Bangladesh, Benin, Brunei Darussalam, Burkina Faso, Cameroon, Chad, Comoros, Djibouti, Egypt, Gabon, Gambia, Guinea, Guinea-Bissau, Indonesia, Islamic Republic of Iran, Iraq, Jordan, Kazakhstan, Kuwait, Kyrgyz Republic, Lebanon, Libya, Malaysia, Maldives, Mali, Mauritania, Morocco, Mozambique, Niger, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, Syria, Tajikistan, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, Yemen.
35. Al-Omar and Abdel-Haq, p. 88.
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38. See Chapter 2.
39. Ibrahim Warde, 'Fastueuses banques de développement', *Le Monde diplomatique*, December 1993.
40. Rodney Wilson, 'The Economic Relations of the Middle East: Toward Europe or within the Region?', *Middle East Journal*, Vol. 48, No. 2, Spring 1994, pp. 285–6.
41. Ibid.
42. Chibli Mallat, *The renewal of Islamic law: Muhammad Baqer as-Sadr, Najaf and the Shi'i International*, Cambridge University Press 1993, p. 120.
43. The other pillars are: the shahada, or professing that 'there is but One God, and Mohammed is his Messenger'; the salat, or praying five times a day; fasting

from dawn to sunset for one month of the year, Ramadan; and, if a believer is able to do so, making at least one pilgrimage to Mecca.

44. Koran 9:60 '[Zakat] charity is only for the poor and the needy, and those employed to administer it, and those whose hearts are made to incline [to truth], and [to free] the captives, and those in debt, and in the way of Allah and for the wayfarer – an ordinance from Allah. And Allah is Knowing, Wise.'
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8

STRATEGIC, MANAGERIAL AND CULTURAL ISSUES

The rapid growth experienced by Islamic financial institutions is likely to last for at least a few more years, driven by the 'money revolution' and by the opportunities of a huge Islamic market that is still largely untapped. But the picture is not all rosy. The Islamic financial market is increasingly competitive, and growing pains have accompanied rapid growth. This chapter focuses on the strategic, managerial and cultural challenges facing Islamic banks. It should be noted at the outset that some of the issues discussed here are common to emerging markets in general and are not exclusive to Islamic banks or even Islamic countries. In most of these countries, there are too many banks, and even the largest ones lack the size and resources to compete internationally. Banks also suffer from an overhang of bad loans, and lag behind their Western counterparts in technology and expertise. The religious dimension nonetheless adds an extra layer of problems. More specifically, this chapter introduces the 'Islamic moral hazard'.

8.1 Competitive Challenges

When modern Islamic finance came into existence, the oil bonanza as well as the novelty of the concept allowed considerable latitude for experimentation. Funds were plentiful for the handful of Islamic institutions that were in a position to share a monopoly on the small but growing niche of clients looking for Islamically-correct investments. Many depositors did not seek any remuneration, thus providing banks with the cheapest possible funding.

In those years, Islamic financial institutions could flaunt their religious character by offering unique financial products. Indeed, prior to deregulation, conventional banks were still stifled by strict controls on product innovation. Strategic and managerial weaknesses could thus be hidden 'behind a curtain of self-righteous platitudes about spiritual ideals'.[1] Such weaknesses have become more glaring with the transformation of the world of finance, and in particular with the inroads made by conventional banks in Islamic finance. Competitive pressures are now appearing from all

sides. This section focuses on two related issues: the Islamic banking franchise, and profitability and social goals.

8.1.1 The Islamic Banking Franchise

A bank's franchise, which can be defined as its 'natural market' (or the reason why customers will normally choose it in preference to other banks), is a key competitive advantage. It is true that the Islamic market has greatly expanded, but it has also become increasingly competitive. Nowadays, every major international financial institution has Islamic operations, and most conventional banks in the Islamic world provide Islamic products, and, increasingly, separate Islamic 'windows'. In interviews with Islamic bankers, one can hear the following sentence repeated over and over again: 'Conventional banks can do anything we do, whereas we cannot do anything they do'.[2] Conventional banks can now have the best of both worlds, offering jointly and to different clienteles both conventional and Islamic products.

Pressures are increasing to force Islamic banks to reconsider their strategy. As the market expands and newcomers multiply, the options available to customers widen, and both depositors and borrowers are likely to demand more innovative products. At the same time, the new norms of global finance are imposing fresh constraints on Islamic financial institutions. They are increasingly pressured to adopt – at the very least if they have international ambitions – new regulatory, accounting, and managerial rules.[3] The transformation and globalization of finance – new delivery systems, securitization, 24-hour trading – have brought with them new rules and norms that are rapidly spreading. Some are being adopted under pressure, often as a component of 'structural adjustment' packages imposed on national economies by international organizations. Others are chosen willingly as a way of gaining credibility and acceptance in the international marketplace. One example would be the attempt to gain the international accreditation standard ISO 9000, which recognizes organizational efficiency, from management style to training to customer needs.

Whereas they were once at the forefront of innovation in their specific market niche, Islamic banks are now lagging, both in the creation and in the marketing of Islamic products. The predicament of Islamic banks is illustrated by the fact that conventional, and usually foreign, institutions are now often in a better position to introduce new financial products.[4] Examples abound of conventional banks being faster to introduce new Islamic products. In Pakistan for example, Grindlays offered musharaka agreements to its clients before any of the Pakistani banks did.[5] Non-Islamic involvement in Islamic banking has become one of the defining features of the second aggiornamento. Not only are many Islamic products

aimed at non-Muslims,[6] but in at least one instance, non-Muslims have started sharing in the ownership of Islamic banks, thus contravening one of the principles of the first aggiornamento.[7] In 1998, three of the largest foreign portfolio investors in Turkey – Alliance Capital Management's Turkish Growth Fund, international financier George Soros's Quantum Emerging Growth Partners, and the Bahamas-based New Frontier Emerging Opportunities Fund – acquired a 10 per cent stake in Ihlas Finans Kurumu, one of the Special Finance Houses. The investors argued that their $4.7 million investment offered investors good value and that the bank was likely to emerge strengthened from the crackdown on Islamic institutions.[8]

The mechanisms by which conventional and Islamic banks make their strategic decisions differ. Conventional institutions proceed through trial and error: countless ideas are considered and new products are launched in short order; a few succeed, most do not. Islamic financial institutions however cannot proceed in the same way, as they are hampered by the religious constraint: new products and new practices must first be cleared by Shariah boards for religious rectitude. Yet in a harsh competitive environment, it is crucial to be swift and innovative: the product cycle is such that in the early stages, profit margins are high but later, as competition intensifies and as the product is commodified, fat margins disappear.

The easy solution is of course to try and compete on the basis of the leniency of Shariah boards, in order to pursue whatever lucrative activities conventional banks are engaged in. The difficult solution is to improve management and lending policies, and in particular to concentrate on what may constitute the Islamic bank's truly differentiating products, those based on profit-and-loss sharing (PLS), a segment now neglected, if not completely abandoned by a majority of Islamic institutions.[9]

8.1.2 Profitability and Social Goals

With the deregulation movement of the 1980s, profitability has displaced size as the principal criterion by which conventional banks are compared and evaluated.[10] Relationship banking is also being replaced by price-based banking,[11] and bank analysts as well as the financial press consider purely financial criteria to be paramount. Islamic banks are a part of the global economy, and they are thus subjected to strong pressures to conform to such expectations. Yet they should not be judged solely on the profit criterion. Since the earliest days, it was clear that Islamic banks should not be driven by profit maximization, but by the provision of socio-economic benefits to their communities. According to the International Association of Islamic Banks (IAIB):

> [T]he Islamic bank takes into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability – despite its importance and priority – is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected.[12]

Islamic banks are quick to point out that they are not charitable organizations, and that they must turn a profit. But this should not be their sole, or even their primary, goal. Banks are expected to achieve a 'reasonable' rate of return (*arbah maakula*), though such a definition has remained imprecise. Some have suggested it should be related to the average return in the economy.[13] In Iran, a maximum rate of profit is determined by the Central Bank.

In the harsh environment of the global economy, banks must compete with conventional banks that usually focus exclusively on profit maximization. This allows them to offer better remuneration to their depositors and to their shareholders. It also allows them to generate the funds necessary to invest in innovation and technology. In 1995 alone, the 10 largest US banks spent more than $10 billion and the 10 largest European banks spent about $12 billion on information technology.[14]

Most strategic decisions involve socio-economic and moral considerations. Where conventional banks can adopt a hard-nosed attitude, engaging for example in ruthless cost-cutting, deciding to get rid of large numbers of employees and of unprofitable lines of business,[15] Islamic banks should consider other, non-financial factors, first. At a time of profit-driven consolidations, mergers, acquisitions and lay-offs, Islamic banks face a dilemma: how can they compete with conventional banks if they do not play by the same rules?

8.2 Management, Control and the 'Islamic Moral Hazard'

The notion of moral hazard is commonly used in connection with financial regulation. It refers to policies that may encourage reckless behaviour.[16] By the same token, one could identify an 'Islamic moral hazard' in that certain features of Islamic finance can encourage unscrupulous behaviour.

For understandable reasons, most scholars steer away from that issue. For many, it is axiomatic that banks and their customers are people of virtue, who act at all times in a righteous manner. While it is undeniable that religious fervour was for many people a reason to work for an Islamic

bank, or to conduct business with it, it was soon discovered that religion could be a double-edged sword. In the Koran there are numerous references to hypocrisy (9:43–9; 110). Since time immemorial, con artists have used the cover of religion as a means of rapid enrichment. Countless financial scandals have involved religious figures.[17] (One cannot help but think of a saying attributed to L. Ron Hubbard, founder of the Church of Scientology: 'If you want to get rich, start a religion'.) Even when the overwhelming majority of people are honest, all it takes is a few bad apples – a few dishonest customers or employees – for banks to incur serious difficulties. Indeed, one big swindle can bring a financial institution down.

Four factors are of special importance in that regard. One is the assumption of righteous behaviour on the part of employees and customers, which sometimes turns certain institutions into a magnet for dubious characters. The second is the use of religion as a shield against scrutiny. The third is the religious and legal ambiguity that often allows borrowers to escape their obligations with impunity. The fourth involves conflicts of interest involving the bank and its clients.

In the early years, Islamic bankers failed to act prudently and exercise the kind of due diligence expected of bankers, because of implicit assumptions about the virtue of their employees and customers. In particular, forays into profit-and-loss sharing activities proved disastrous. Bank executives acknowledged that they had trusted people who did not deserve their trust.[18] Hassan Kamel, chief executive of the (now-defunct) London branch of Al-Baraka, explained why his bank was not involved in profit-and-loss sharing (PLS) operations: 'The depositors wanted an Islamic deal without risk. They liked, at least, to guarantee their capital. The problem with PLS is that (the Islamic economists) assume the scenario of the entrepreneur being a good Muslim'.[19] Hamid Algabid noted that the same problem was encountered by most Islamic institutions:

> At the beginning, confidence was the rule. The good faith of the participants could not be questioned since it was identified with religious faith. Since spiritual and temporal matters could not be dissociated, a pious man could only act in good faith. Experience has since shown that banking operations could not be based on that assumption, and particularly that guarantees could not be limited to the affirmation of one's Islamic faith.[20]

Internal control has also been a problem for the same reasons. In 1998 alone, the Dubai Islamic Bank, the oldest and one of the largest Islamic commercial banks, was hit by two scandals involving its employees. It incurred losses of $50 million when, according to a bank spokesman, 'a bank official extended business loans without conforming to the bank's credit terms'.[21] News of the losses caused a run on deposits: in one day, DIB clients are said to have withdrawn $138 million (or 7 per cent) of the bank's

total deposits, forcing the Dubai Central Bank and the United Arab Emirates authorities to ride to the rescue, and provide the liquidity and the guarantees necessary to reassure depositors.[22] Another, more bizarre, swindle also involved a large, unauthorized loan. In a lawsuit filed in Miami, Florida, the Dubai Islamic Bank charged West African tycoon Foutanga Dit Babani Sissoko of bilking it of $242 million. A branch manager, who claimed that he gave the funds to Sissoko because he was under his 'black magic' spell, was arrested.[23]

A second type of Islamic moral hazard occurs when the financial activities of certain Islamic institutions or groups become immune to scrutiny or criticism, whether for political or religious reasons. In Iran for example, a whole sector of the economy has been able to operate outside of any regulatory framework, allowing abuses to persist and go largely unpunished:

> Mullahs in control of [foundations], and their appointed managers are hardly accountable, and run them as personal fiefs. Widely publicized corruption scandals and investigation by the Majlis led to the resignation of certain clerics in charge in late 1994 and 1995. But the foundations are still widely believed to foster nepotism and patronage, which adds to their political clout.[24]

A more subtle but equally pervasive form of Islamic moral hazard is the advantage that can be taken from ambiguity. Unlike secular systems, the legal system of Islam incorporates both an economic and a religious logic. In the words of Noel Coulson:

> Commercial law … in the West is orientated towards the intrinsic needs of sound economics, such as stability of obligation and certitude of promised performance. In the religious law of Islam, on the other hand, equitable considerations of the individual conscience in matters of profit and loss override the technicalities of commercial dealings. It is the harmonization of these two very different approaches which poses the real challenge for developing Islamic law today.[25]

Islamic banks face a serious problem with late payments, not to mention outright defaults, since some people take advantage of every dilatory legal and religious device. Indeed, like other religions, Islam recommends forbearance and even loan forgiveness to borrowers in difficulty (Koran 2:280–1). In a secular system, such prescriptions can be ignored. But in a religious or hybrid system they cannot. Secular bankers can use a whole array of tools – such as late fees, lawsuits, forcing bankruptcy, etc. – to protect their interests as lenders. Islamic bankers are hampered by the lack of clear-cut norms and remedies. In most Islamic countries, various forms of penalties and late fees have been established, only to be outlawed or considered unenforceable.[26] Late fees in particular have been assimilated

to riba. As a result, 'debtors know that they can pay Islamic banks last since doing so involves no cost'.[27] In Pakistan, special banking tribunals have been created, but they are in competition with other tribunals and lack enforcement power. Attempts to expedite court processes typically are still bogged down by religious objections.

It should be noted that the same problems often hurt conventional banks in Islamic countries. In Saudi Arabia, problems of late payment are endemic, and banks receive little help from the judicial system. Peter Wilson observed that 'Saudi Arabia's bad loan problem is as old as the country's banking system, given the doctrinal dilemma of having an interest-based financial system in a country that officially prohibits interest.'[28] More specifically:

> The Kingdom's law courts reflect the uneasy balance in the country. There are Islamic or Shariah courts that fall under the jurisdiction of cleric-dominated Ministry of Justice and special commercial committees under the sway of the more progressive finance and commerce ministries. Enforcement, however, remains the domain of the Interior Ministry and each province's governor. The result is a legal quagmire, as the country's economic development has overwhelmed the abilities of the existing courts. Besides having to cope with an inadequate legal code, courts also have to contend with another force as well: the more than 7,000 princes who comprise the House of Saud and who in practice are beyond the jurisdiction of any court.[29]

In Pakistan, many borrowers took advantage of the ambiguity of a multi-layered legal system to avoid repaying much of their debt. Many businessmen who had borrowed large amounts of money over long periods of time seized the opportunity of Islamicization to do away with the accumulated interest of their debt, by repaying only the principal – usually a puny sum, considering years of double-digit inflation.[30]

The fourth type of Islamic moral hazard is related to the bank's relation with its depositors. Islamic banks share their profits with those of their customers who hold investment deposits. For example, 80 per cent of the net profits may be distributed to the depositors, and 20 per cent to the shareholders. Empirical surveys have shown that banks often arbitrarily change distribution ratios. When profits decline, depositors often still expect a competitive rate of return, or else they may take their savings to another Islamic institution, or to a conventional bank. Thus in Egypt, from the mid to the late eighties, the International Islamic Bank for Investment and Development (IIBID) distributed all its profits to investment account depositors, while the shareholders received nothing. In 1988, the bank even had to distribute to its depositors an amount exceeding its total net profit. The difference appeared in the bank's account as 'loss carried

forward'.[31] Clearly such practices fly in the face of sound banking management practices, and cannot be sustained for long, yet they are likely to happen in the absence of strict regulatory controls.

Islamic banks also suffer from the lack of an adequate infrastructure. The Islamic financial community is too fragmented, it lacks industry-wide norms and a true secondary market. The complex nature of the industry – national and transnational, its being subjected to both secular and religious norms – complicates the managerial task. On matters of accounting, attempts at harmonization (such as those of the Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI]) have met with resistance. Indeed, different accounting rules can make a big difference in a bank's performance and solvency. Non-cash items can be used to inflate profits. An institution's holdings of real estate, stocks or bonds can be valued 'historically', that is, according to their initial purchase price, or 'marked-to-market', that is, according to their current market value. Similarly, an infinite variation of rules occurs in case of non-payment or late payment. In certain countries, rather than declaring an entire loan past due, each instalment is declared past due; also, interest income not received can be capitalized; and new credits can be extended to borrowers in difficulty, thus postponing default.

Perhaps the most vexing managerial issue is the lack of qualified personnel. Bank officers must possess at once management skills appropriate to a conventional institution and religious training. The need (admittedly mostly theoretical) for expertise in profit-and-loss sharing also requires that the Islamic banker combines the skills of the commercial banker with those of the venture capitalist – which further reduces the pool of available talent.[32]

There are countless seminars, training programmes and educational facilities, but most have been found to be inadequate for a variety of reasons ranging from the fragmentation of the industry to the inadequacy of the state of knowledge and scholarship in the field. In 1981, the International Institute for Banking and Islamic Economics opened in Cyprus. It was the most ambitious programme ever, sponsored by all the existing Islamic banks, the Islamic Development Bank (IDB), and a number of governments and universities. The Kibris Islamic Bank was even created to serve as its 'application bank'. But both the institute and the bank closed abruptly after a few years, under mysterious circumstances.[33]

8.3 Marketing Issues and Challenges

Researchers asked 10 customers of a now-defunct Islamic bank in London why they had deposited their money with that bank: 'Eight of them said they had done so because it was Islamic. All of them said they were disappointed with the services and the treatment they got from the bank.'[34]

Today, given the intense competition in Islamic finance, few banks could retain such customers. Many banks are actually attempting to sharpen their marketing skills to attract and retain customers.[35] At the heart of the marketing effort lie a few basic questions: who are the actual and potential customers of Islamic financial institutions? What are their motivations and behavioural characteristics? What should banks do to reach them? Should the institution compete on the basis of religious credentials or on the basis of products and service?

There are two sets of reasons why people choose to deal with an Islamic financial institution. One is religious/solidary, the other is financial/commercial. In the early years, there was an implicit trade-off between the two since there often was a financial or commercial penalty in dealing with an Islamic institution. Remuneration on deposits, when it existed, was usually lower. The financial institution was also likely to lack experience and expertise and offer little convenience. To be sure, there was the possibility that returns on profit-and-loss sharing accounts would be higher than conventional interests, but such accounts also carried the risk of loss of all or part of the principal.

The early assumption of Islamic finance was that the devout would be willing to sacrifice a share of their wealth as an act of faith, or to express solidarity with their community. To use an economic formulation, the lower rate of return would be a premium paid by a Muslim to satisfy his religious preference. At least, such were the expectations of the first Islamic bankers.[36]

To this day, it is hard to truly measure the relative importance of the two factors. For one thing, as in any human endeavour, motives are complex. For another, surveys can be misleading since respondents are always likely to exaggerate the role of the religious motive. In addition, the sheer diversity of the 1.2 billion-strong Muslim community worldwide makes any generalization based on a small sample hazardous.[37] This is frustrating from the standpoint of bank marketing. Indeed, while there are countless marketing tools available to segment markets and analyze customers' needs and characteristics,[38] the religious dimension remains elusive.

Perhaps the best way of approaching an answer is to state an axiom: given a choice between two identical products (or two identical banks), one conventional and one Islamic, the devout Muslim will choose the Islamic one. This of course may not resolve the issue, since neither products nor banks are ever absolutely identical, yet it helps explain the growing convergence between Islamic and conventional banks (conventional banks creating Islamic products, windows, or subsidiaries; Islamic financial institutions broadening their product range, adapting to conventional benchmarks and appealing to non-Muslims).[39] This in turn poses another marketing question: are all Islamic banks and products equally Islamic?

Surveys show that the two decisive factors in deciding whether an institution is truly Islamic are, first, the existence of a Shariah board, and second (in the case of establishments that offer both conventional and religious products), whether there is a clear segregation of funds and operations. Other issues, such as the ownership of the institution (whether it belongs to a Western bank, for example) or whether they may cater to non-Muslims, seem to matter little.[40]

Not surprisingly, the religious dimension is the central part of the marketing effort of financial institutions. With various degrees of subtlety, marketing campaigns have warned against the ills of 'usurious interest', denigrated their 'usurious' competitors,[41] and associated success with religion. For example, one of the advertising slogans of the Egyptian Islamic Money Management Company Al-Rayyan was 'al-baraka wara al najah' or 'the blessings behind success'.[42] Marketing campaigns are usually stepped up during the holy month of Ramadan.[43]

Religious symbolism is visible in most Islamic financial institutions. The building and decor often reflect Islamic architecture. Koranic sayings often adorn the walls. Banks usually include a prayer room to help employees and customers fulfil salat, the Islamic obligation to pray five times a day. Beyond the traditional savings and checking accounts, banks often offer a haj fund, designed to help customers save for a pilgrimage to Mecca. Those institutions located outside the Islamic world (where Friday is therefore a working day) usually close from 11am to 3pm on Fridays. Some even close during the day to allow their employees and customers to perform their prayer obligations.

8.4 Problems of Liquidity

During the Gulf War in 1991, the Islamic banks in the Gulf region lost about 40 per cent of their deposits.[44] This highlights the vulnerability of Islamic financial institutions and justifies somewhat their aversion to risk. Lacking a deposit insurance programme that can reassure depositors and prevent massive withdrawals, Islamic institutions cannot depend on the flexibility afforded either by a secondary market, or by a ready discount window. Opportunities for securitization are limited, and there is no true Islamic interbank market to help fund daily liquidity. Conventional banks, in contrast, can reassure their depositors by providing deposit insurance. They also have flexibility in managing their assets and liabilities by reselling their loans to other financial institutions, by transforming those loans into tradable securities, using the discount facilities of their central bank, or borrowing at interest.

Of all the main financial instruments used by Islamic banks, only leasing operations can easily lend themselves to secondary trading. In the Islamic tradition, discounting debt obligations (selling them for less than their

face value) usually raises riba-related issues. The buying and selling of financial obligations is still controversial. In addition to the lack of a true Islamic banking infrastructure and interbank market, they face another (albeit mostly theoretical) hurdle: the ties between borrower and lender are supposed to be such that they cannot be casually severed.[45]

Coordination and homogenization are complicated by the disagreements among Shariah boards as to what activities are permissible, and how Islamic banking operations ought to be conducted. The very idea of creating an Islamic interbank market – perceived by some as buying and selling money – still divides them. In addition, bitter disagreements within the Islamic finance community[46] along with rivalries between financial institutions as well as countries have prevented the emergence of a true community of Islamic banks, whose role could theoretically be similar to that of nineteenth-century clearing houses. These were coalitions of banks created in the era predating modern bank regulation to address the problem of banking panics as well as other areas of common concern. They monitored member banks by restricting their activities, conducted strict bank examinations and enforced compliance. At times of financial panic, they would provide reassurance of repayment to depositors.

Over the years, there has been no lack of attempts at providing coordination and at promoting uniform practices. In 1981, on the occasion of the Fourth Meeting of Central Bank Governors in Khartoum, the Report of the Experts Committee on the Promotion, Regulation and Supervision of Islamic Banks was approved, with the recommendation that individual countries adopt it.[47] Yet the heterogeneity of Islamic financial institutions characteristic of the second aggiornamento has complicated that task. At a time of increased coordination among international financial institutions, Islamic financial institutions are lagging.[48] A few initiatives are nonetheless worth mentioning. The Arab Banking Corporation (ABC) has formed a clearing company that acts as a fund which invests in Islamically acceptable products. Banks can invest their excess balances in the clearing company for two to three days and receive a guarantee from ABC on the principal they put in plus the accrued profit for the period. In addition, the Islamic Development Bank has increasingly taken up the role of lender of last resort to Islamic institutions.

8.5 Cultural Issues and Challenges

Every community or institution has, in the anthropological sense, a culture. Culture has been defined as 'everything that people have, think, and do as members of their community'.[49] It is principally about ideas, values and attitudes as well as normative or expected patterns of behaviour. By the same token, every bank can be said to have its own culture: 'A bank's shared values constitute its culture. Such cultural values may relate to how

communications take place, how decisions are made, or how people get ahead in the organization. They are the signature, the "what makes us different", of a bank.'[50]

Pressures are increasing to force Islamic banks to reconsider their focus on short-term mark-up based deals and seek longer-term profit-and-loss sharing projects. Perhaps the greatest obstacle is a cultural one, related to risk and trust. Given the diversity of the Islamic world, a common cultural denominator is elusive. Many authors fear to tread on that ground for fear of appearing unscientific or politically incorrect. Yet the reality of the cultural element is inescapable.[51] Although a lot in this section is anecdotal and country-specific, broader patterns will emerge to account for the difficulties in developing profit-and-loss sharing arrangements that are at the core of the Islamic banking philosophy.

Culture is notoriously tricky to analyze. It is multifaceted, somewhat amorphous and hard to pin down; it is closely intertwined with history and institutions. Culture does not emerge in a vacuum. It is the product of historical processes and socio-economic variables. It is significant from our standpoint because it influences investors' preferences: in an uncertain political and economic environment, people like to hold gold; people accustomed to high inflation favour real estate and tangible assets; minorities who fear confiscation and expulsion feel safer owning jewellery and valuables that can be transported.

Different Islamic communities have had different histories, and thus different relations to money. Historical and anthropological observations capture some of these differences. Maxime Rodinson has noted, for example, 'the traditions of generosity for the sake of prestige, familiar to the leaders of the desert communities'.[52] Such a trait has undeniable political, economic and financial implications in today's patrimonial Gulf states.

In contrast, the image of financiers and businessmen as entrepreneurs à la Schumpeter, who thrive on risk and creative destruction, does not quite fit much of the contemporary Islamic context. Conservatism and risk-avoidance are the rule. Consider for example this description of the typical Egyptian businessman:

> A Cairene entrepreneur, even one who faces no serious competition, still has to cope with unpredictable changes in inflation, vacillating exchange rates, and capricious government policies. The country lacks genuine capital markets, so the odds are that the entrepreneur's capital represents the sum of his family resources, either saved over long years or inherited from some glorious ancestor. One of the reasons that rent seeking is such a popular technique among businessmen is that it holds risk to a minimum. It is a way of getting the government to guarantee against the risks of certain ventures. As a result, Egyptian businessmen are not unimaginative, but they are justifiably cautious.[53]

Risk avoidance, given their experience and the environment within which they operate, is perfectly rational behaviour for many entrepreneurs. Long-term investment requires a culture and institutions that are predictable and foster trust.[54] In order to take a calculated risk, the entrepreneur will expect political and economic stability in his environment, and consistency in the enforcement of the law. In much of the Islamic world, people still have memories of expropriation and arbitrary decisions by governments that have adversely affected their business ventures.[55] Rampant inflation also discourages long-term investment, and so do currency fluctuations which can wipe out savings overnight.[56]

Another factor is that the worlds of business and finance are likely to be politicized and embedded within social institutions (family, tribe, ethnic or religious group). 'Connected lending' (lending to entities otherwise related to the financial institutions) tends to be very high, and when loans go bad, custom and social mores prevent the use of modern enforcement techniques (foreclosures, forced bankruptcies, etc.). The protection of the law is not always assured, and the Islamic moral hazard discussed earlier is likely to make things worse. In many countries, delaying payment is a common practice, and defaulting borrowers – provided that they are well connected – are beyond the reach of the law.[57]

In that environment, successful financial institutions are often the most conservative ones. They are therefore unlikely to engage in risky entrepreneurial finance. Edmond Safra, scion of a Syrian Jewish family that had been involved in banking for generations, who later went on to create a financial empire in Switzerland, Brazil and the United States, and is still the preferred banker of many Middle Eastern potentates, states his philosophy of banking as follows:

> The book on banking was written 6,000 years ago. Banking is a simple, stupid business. First and foremost, you safeguard depositors' money – you, the banker, not the Federal Deposit Insurance Corporation. You invest it safely and pay your depositors a little less than the interest you receive. You keep your expenses low.[58]

His banking precepts were inherited from a long tradition.[59] One precept he learned from his father was that 'if you loan a man too much money, you turn a good man into a bad man'.[60] This may be an apt, if – considering the bad loan problems encountered by many Middle Eastern banks – forgotten, piece of advice.

The oil windfall has to some extent corrupted many elements of Middle Eastern business and finance, creating get-rich-quick mindsets and favouring greed. The propensity to speculate in international financial markets and sometimes in domestic ones may seem paradoxical, given the conservatism noted earlier (and of course in the light of the religious teachings of Islam), but it is easy to explain. Empirical studies show that

investors in a bullish market, especially when they think they are (by virtue of their 'connections') insiders, often feel that speculative risk is preferable to productive risk.[61] Safra's general comments hint at the cultural and institutional difficulties associated with a more complex, participatory form of finance such as profit-and-loss sharing.

Many observers have noted the correlation between Islamic views of risk and contemporary practices, especially in the Arab Middle East.[62] As other parts of the book show (in particular Chapter 3), the injunctions against gharar are not injunctions against risk per se, but against speculation and uncertain contracts as well as against selling and otherwise transferring risk to third parties. Also, the prohibition of riba has made finance as a whole suspicious in the eyes of many Muslims. Perhaps the major remaining obstacle is in achieving coherence and consistency in laws and institutions, in the hope that in due course it will transform the culture and eliminate the Islamic moral hazard.

In justifying the paucity of long-term investment, there is a lot of blame to go around. Governments do not offer sufficient incentives: '[I]ndividuals and enterprises are at the mercy of administrative interpretations and applications, and can only succeed through the informal facilitation and evasions of bureaucratic functionaries'.[63] Banks, reluctant to develop PLS products, set the bar so high that few investments qualify. Many borrowers have manipulated the system to their advantage. Only a concerted effort can resolve the problem. The challenges ahead are two-fold: banks themselves need to work at transforming their cultures; they also need to work at changing their surrounding political and business culture. Indeed, the necessity of change may be expressed in economic terms, but strong political impediments stand in the way.[64]

As a first step, Islamic banks must work to change their own operations, procedures and culture. A prerequisite to instilling a culture fostering the development of profit-and-loss sharing products is a better understanding, on the part of bank managers and executives, of the logic of venture capital.[65] This will result in the creation of successful, long-term oriented products and in turn, by building a track record, instil the necessary confidence in the public.

The challenge of cultural change is all the greater in that it should not simply consist in adopting the culture of global finance, with its often predatory and amoral features, but should temper it with the moral values of Islam. Nabil Saleh wrote:

> It is not uncommon, in secular transactions, for one of the parties to be stronger than the other, or perhaps cleverer or more experienced; so the disadvantaged party is in need of some kind of protection and guidance before an agreement is concluded or a bargain struck. This was even more the case during the Prophet's time, when substantial difference in terms of enlightenment and development existed

> between bedouins and townsmen, and even between townsmen belonging to different settlements. One established hadith tells that Muhammad forbade a transaction known as talaqi al-rukban, which is a sale whereby a townsman meets a tribesman outside the market place and buys the tribesman's goods at a price cheaper than the price prevailing in the market, thus taking advantage of the seller's ignorance of the market price.[66]

One cannot help but relate this quote to contemporary accounts of the brave new world of finance. In his account of his experience as a mortgage bond salesman at Salomon Brothers, Michael Lewis describes the ways in which today's 'townsmen' (New York traders) fleeced the 'tribesmen' (regional Savings and Loans managers). He writes:

> The men on the trading floor may not have been to school, but they have Ph.D.'s in man's ignorance. In any market, as in any poker game, there is a fool. The astute investor Warren Buffett is fond of saying that any player unaware of the fool in the market probably *is* the fool in the market. … Salomon bond traders knew about fools because that was their job. Knowing about markets is knowing about other people's weaknesses. And a fool, they would say was a person who was willing to sell a bond for less or buy a bond for more than it was worth. A bond was worth only as much as the person who valued it properly was willing to pay. And Salomon, to complete the circle, was the firm that valued the bonds properly.[67]

Similarly, Lewis identifies the inevitable conflicts of interest that accompany financial innovation: 'If it was a good deal, the bankers kept it for themselves; if it was a bad deal, they'd sell it to their customers'.[68]

Or consider Frank Partnoy's account of his experience selling complicated derivatives such as repackaged asset vehicles (RAVs), and principal exchange rate linked securities (PERLS) for Morgan Stanley. Such risky vehicles – 'complex foreign exchange bets packaged to look like simple and safe bonds' – were sold to unsuspecting clients. The following quotes encapsulate the culture of the derivatives business:

> Morgan Stanley carefully cultivated this urge to blast a client to smithereens.

> No one seemed to care about whether clients actually understood what they were buying.

> A salesman cared only about making the sale, not about the damage it might cause later. All derivatives salesmen knew that eventually some of their trades would blow up, and some of their clients would then go up in flames.

Wall Street has made, and continues to make, a huge amount of money on derivatives by trickery or deceit.

Derivatives are the most recent example of a basic theme in the history of finance: Wall Street bilks Main Street.[69]

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6. See Chapter 4.
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30. Al-Omar and Abdel-Haq, p. 101.
31. Kazarian, p. 179.

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9

ECONOMIC ISSUES: ISLAMIC FINANCE AND DEVELOPMENT

Insofar as '[m]oney is the only good that trades against all other goods', the financial sector 'is unique in the degree to which its markets, prices, institutions, and policies impinge upon all others.'[1] More specifically, in any modern economy, financial systems are central to long-term economic development:

(1) They facilitate trade: at the most rudimentary level, money minimizes the need for barter and thereby encourages commerce and specialization.

(2) They facilitate risk management, by pricing risk and providing mechanisms for pooling, ameliorating, and trading risk.

(3) Financial intermediaries mobilize resources from disparate savers to investment in worthwhile investment projects.

(4) Financial systems obtain information, and evaluate firms, projects and managers.

(5) Financial systems provide corporate governance. It is difficult if not impossible for individual investors to evaluate and monitor the performance of firm managers. Consequently, financial intermediaries are often charged with compelling managers to act in the best interests of firm claim holders (stockholders or creditors).[2]

Promoters of Islamic finance have argued that Islamic finance was not only consistent with capitalism (i.e., with a market-driven allocation of resources), but that it was in many ways better suited to a dynamic economy. More specifically, Islamic finance could bring about more efficient mobilization of savings, more equitable and just distribution of resources, more responsible and profitable lending, as well as less volatile business cycles and more stable banking systems.[3]

This of course is the theory. The difficult part has been to translate the broad principles of Islamic finance into concrete reality. More specifically, in order to contribute to the process of economic growth and development, banks must learn how to transform savings into real investments, and

how to do it efficiently – transforming small deposits into larger loans, acting as risk arbitrageurs for investments with different rates of return and risk levels, devising an attractive mix of financial instruments, etc. Following some comments on Islam and economic liberalism, this chapter considers four sets of economic issues and challenges: the mobilization of savings, economic development and fund allocation, Islamic capital markets, and macro-economic policies.

9.1 Islam and Economic Liberalism

Dominant approaches to development have changed dramatically since the 1980s. Until then, development theorists emphasized 'top-down' industrialization, with the state playing the main role in the economy. Economies were supposed to grow through centrally planned development and import substitution policies.[4] Even in those countries committed to free enterprise, government agencies in charge of economic development established broad policy guidelines, and the role of the state kept increasing. The nationalization of oil and banking in Saudi Arabia and other Gulf states in the 1970s is a case in point. In most countries, the financial sector was used as a tool to implement the developmental goals of governments.[5]

Since the 1980s these policy dogma have been reversed: export-led industrialization, privatization and disengagement of the state have become the order of the day. The growing interest in Islamic economics and finance is not unrelated to these policy developments.[6] In the words of Karen Pfeifer:

> Far from being a throwback to the social system of the Middle Ages, Islamic economics is … a set of ideas evolving in the last decades of the twentieth century to explain and address the economic problems faced by the citizens of predominantly Islamic countries. Islamic economics responds to the achievements and failures of, first, state capitalism, and, second, the international capitalist system's antidote to state capitalism – economic liberalization.[7]

One should however be wary of drawing broad conclusions in regard to state–market or public–private relations. In assessing Egypt's infitah (open-door) policy, Robert Springborg observed:

> Instead of undertaking basic structural reforms which would create an environment truly conducive to private investment, the government of Egypt has been preoccupied with tinkering with the legal superstructure. The tinkering has produced some more liberal conditions governing investment, but the gain is partially offset by uncertainty resulting from the tinkering itself. Moreover, even while

seeking to entice private investment through special incentives, the Egyptian authorities have presided simultaneously over the further expansion of the state's role in the economy. Public revenue as a percentage of GDP climbed steadily during the infitah, rising from 34.4 percent in 1975 to 43 percent in 1984. The state, far from withdrawing from this arena in favor of private enterprise has occupied a greater share of it.[8]

9.2 The Mobilisation of Savings

9.2.1 The Special Role of Banks

In most Islamic countries, banks are by far the main source of finance because alternatives, such as capital markets, are under-developed. They operate the payments systems, purchase most government bonds, and are essential to the operation of all parts of the economic system. In such an environment, banking assets tend to grow much faster than the economy as a whole. Conversely, since banks hold the lion's share of financial assets and are the dominant financial intermediaries, banking crises tend to hit developing economies particularly hard.[9]

The Bank for International Settlements (BIS) has noted that rapid economic growth in the 1990s 'has led to an extraordinary expansion in the ratio of bank credit to GDP that has no recent parallel in the industrial countries'. The ratio in Indonesia rocketed from 8.1 per cent in 1980 to 49.1 per cent in 1995. In Malaysia the figures are 33.1 per cent and 76.9 per cent. (In the US in the same period the ratio rose from 62.1 per cent to just 63.3 per cent.)[10] Such rapid growth is likely to create 'lending bubbles' as abundant funds chase a limited number of truly creditworthy ventures and tend to concentrate in short-term and speculative areas. As soon as a downturn occurs, many of these loans are likely to become irrecoverable and the cost of supporting, recapitalizing or restructuring the banking sector is likely to amount to a large percentage of the Gross Domestic Product (GDP).

Banking in much of the Islamic world also tends to epitomize 'crony capitalism'. To an even greater extent than in industrial countries, banks in emerging markets have very close ties with governments, and bankers are likely to belong to close elite circles.[11] In its survey of Middle Eastern billionaires, *Forbes* notes that banking is a 'proven route to riches': 'All of the 11 billionaires and 2 of the heavy hitters from the region are bankers or own stakes in banks.'[12] One of the consequences is that regulators often come under pressure to turn a blind eye to the imprudent practices of some bankers. '"What do you do if the president's brother owns a bank," asks one Southeast Asian supervisor. "The answer is you leave him alone"'.[13]

Within such an environment, the role of finance is skewed. Rather than going to worthwhile investment projects, financing goes primarily to 'well-connected' borrowers. Other functions mentioned above – obtaining information, evaluating firms, projects and managers, and providing corporate governance – are similarly distorted. Also, banks are often considered 'trophies' that inexperienced businesspeople pay a high price to acquire, and sometimes mismanage, at a high cost to the economy as a whole.[14]

9.2.2 Informal Finance

In most developing countries there is an informal or parallel financial sector that is unregulated and does not appear in official accounts. It includes black-market money changers and traders, but also deposits and savings accounts as well as loans. One mechanism, known as rotating savings and credit associations (ROSCAs), is described as follows by the World Bank:

> ROSCAs intermediate in the most basic way. A small number of individuals, typically six to forty, form a group and select a leader who periodically collects a given amount (a share) from each member. The money collected (the fund) is then given in rotation to each member of the group.[15]

Historically, informal markets have emerged either out of the inability of the official sector to accommodate certain types of transactions, or out of the refusal of certain groups – for a variety of reasons ranging from lack of trust or fear of confiscation, to the avoidance of currency-reporting requirements, to tax evasion – to integrate the official government system. Within informal networks, religion, ethnicity, kinship or neighbourhood affiliations provide a sense of trust and act as substitutes for legally enforceable obligations.[16] The risk of social ostracism is indeed an effective enforcement mechanism.[17]

Economists disagree as to the merits of informal sectors. For hardcore free-marketeers, such sectors – insofar as they emerge spontaneously and are not 'distorted' by government intervention or hamstrung by 'financial repression' – represent true markets.[18] According to this view, a combination of excessive regulation, artificially low interest rates – which act as a disincentive to savings – and directed credit – which in effect subsidizes certain sectors, certain groups, and certain regions at the expense of others – is harmful to economic development.[19] In countries such as Yemen, the informal banking sector has for a long time been a factor of economic stability.[20]

Critics however see inherent limits in informal markets. They are likely to remain small-scale, and thus exclude significant segments of the

population. And conversely, if they expand too fast (as was the case with Egypt's Islamic Money Management Companies [IMMCs]) they are even more prone to fraud and abuse than the official sector under comparable circumstances. They also deprive the government of much-needed revenues and prevent the conduct of a coherent macro-economic policy.

This is where Islamic finance can be seen as an attractive middle ground. One of the strong selling points of Islamic finance is that it attracts funds that would otherwise have remained outside the national financial system – sent abroad, kept 'under mattresses' or otherwise hoarded, or at best confined to the informal sector. In the Islamic world, two main reasons are said to account for the refusal of some people to deposit their money in banking institutions: religious factors relating to interest payments, and the lack of trust in domestic financial institutions – the fear that they will collapse or that deposits will be confiscated by the government.[21]

Estimates as to the amounts left out of traditional banking circuits vary. Hikmet Guler, general manager of Turkey's Faisal Finance Institution Inc., estimated that Turks were holding $50 billion outside the banking system.[22] Assuming that the estimate is realistic, the implication – in a country with a parallel Islamic sector that has only $1.5 billion in deposits – is that were Islamic banks allowed to expand and operate with fewer constraints, most of these funds would find their way into the official banking sector.

Yet it is not enough to create Islamic financial institutions. Such institutions must provide the necessary facilities, inspire confidence and provide attractive investment options. Insofar as conventional banking is usually concentrated in prosperous enclaves and barely penetrates poor, rural, and remote areas,[23] the task of Islamic institutions is to fill that gap. But expanding a network to rural areas and servicing small accounts are not the best ways of building profitable operations.

Perhaps even more difficult than the logistical aspects are the psychological ones. In areas where people are used to keeping their (usually meagre) savings under the proverbial mattresses, the language and symbolism of religion may help, but is likely to be insufficient, at least from a developmental perspective. Indeed, a further challenge to Islamic banks is to promote investment accounts, that is, accounts that will serve to finance profit-and-loss sharing operations. In contrast to conventional savings accounts which are usually short-term (and often insured), these accounts are oriented toward the long-term, and their fate depends on the success (or failure) of the corresponding investments. The possibility of losing one's savings does little to reassure the suspicious. Hence the need to engage in a serious education and marketing effort, and most importantly to make a sustained effort at building confidence and a track record. Financial institutions must develop instruments that are convenient to small savers, intelligible to people unaccustomed to modern banking, and remunerative enough to be appealing.[24]

9.2.3 Assessing the Performance of Islamic Banks

There are no comprehensive or comparative surveys on the subject, but anecdotal evidence as well as a number of case studies suggest that the promise of bringing into the system a heretofore neglected segment of the market has not been fulfilled. Elias Kazarian's study of the Egyptian case suggests that much of the increase in Islamic bank deposits occurred at the expense of conventional banks (and was driven by the increase in the remuneration of accounts); that most of the activities of Islamic banks have been in large cities as opposed to the countryside, where they are most needed;[25] and that their main customers were likely to be the well-to-do, and not the poor or the lower middle class.[26]

9.3 Islamic Banks and Economic Development

In the process of transforming savings into investments, Islamic financial institutions are different from conventional lenders insofar as they must take into account social and developmental factors. In that respect, Islamic banks are expected to play the role once played by state banks and development agencies. Those functions, as described by the *Handbook of Islamic Banking*, can be summarized[27] as follows:

– Broad social-economic benefits: investment policies must reflect the needs and the aspirations of the majority of the population, which must be included in the development process. Banks must favour projects in the food, housing, and health services sectors, in order to ensure their adequate supply and affordability.

– Job creation and focus on promising economic sectors: the emphasis should be on value-added sectors, as well as those sectors favoured by national plans and objectives. Such sectors include agriculture, industry, and technology-intensive activities because of their potential for job creation, improvement of the balance of payments, and the promotion of technology and education.

– The promotion and stimulation of entrepreneurship: through profit-and-loss sharing (PLS) mechanisms such as mudaraba and musharaka, banks must give priority to small enterprises. Financing must be specific to each firm's economic and financial conditions. Banks must provide technical advice in order to improve the process of production. After a venture becomes self-sustaining, the bank should sell its share to the entrepreneur or other beneficiaries, in order to free up funds that can be used to finance new ventures.

– The promotion of social justice and equality and the alleviation of poverty, through the establishment of a zakat fund, for the collection

and distribution of funds to the poor, and the provision of interest-free loans (qard hasan) to deserving individuals.

– The regional distribution of investments must follow two sometimes contradictory principles: the promotion of regional balance, i.e., channelling money to under-invested areas thus forestalling the need to migrate to more prosperous areas, along with the principle of investing savings mostly in the area where they have been mobilized, thus ensuring that people benefit from their savings.

Those ideals reflected the mood and values of the period of the first aggiornamento. For one thing, state planning and top-down industrialization were still the norm. There was also a heady sense of solidarity and new beginnings, mixed with populism. For example, Islamic banks were not allowed to take part in the production and marketing of luxury activities (israf wa taraf), at least not until the basic needs of society were met.[28] Islamic finance was perceived as the key to economic development, providing long-term funding to businesses that would otherwise have no access to finance. More generally, it was supposed to bring about balanced economic development, social justice, and an equitable distribution of income and wealth.

Undoubtedly, the gap between promise and performance was greatest in the area of economic development. Despite the support and special privileges (such as guarantees against nationalization) obtained by Islamic banks, they behaved like risk-averse agents. The early goal of concentrating on profit-and-loss sharing was soon abandoned. The objective of penetrating the hinterland and serving rural areas was not fulfilled.

Most evidence highlights the tendency of Islamic banks to invest in short-term commercial transactions as opposed to industry or agriculture. In Sudan, an agricultural country, only about 4 per cent of the investments were allocated to agriculture while 90 per cent went to import–export operations.[29] In Egypt, statistics compiled between 1979 and 1991 compared Islamic banks unfavourably with conventional banks on matters of productive and domestic investment. Not only were Islamic banks less likely to invest in industry or agriculture, but they were more likely to invest their money abroad and to keep it in foreign currency.[30]

9.4 Islamic Capital Markets

Islamic finance, with its long-term, equity-based orientation, was supposed to be an acceptable substitute for capital and stock markets. But as we saw, banks have been reluctant to finance mudaraba and musharaka operations. There is thus a renewed interest in creating and nurturing national financial markets – all the more so since capital and equity market, usually considered the most efficient means of financial intermediation, are

almost a prerequisite to participation in the global economy. A number of factors are driving the trend towards the creation of national capital and equity markets: the new ideological consensus, pressures from international organizations, privatization and deregulation, the emergence of large institutional investors, etc.[31] Such markets present a number of advantages: they broaden the options of investors; they attract and encourage national saving as well as the repatriation of funds held abroad; they attract foreign investment; they provide much-needed liquidity; they encourage sound management and good corporate governance, etc.[32] At the same time, they present substantial risks. The Souk el-Manakh experience (the collapse of the informal Kuwaiti stock market in 1982) – whose financial fallout (estimated at $40 billion) is felt to this day in the Kuwaiti banking system – is still a vivid memory. Foreign investment is sorely needed, but fickle short-term capital that comes and leaves suddenly increases volatility and can have a destabilizing effect on the economy as a whole.

One of the main problems with capital markets is their potential for speculative excess, which poses economic and religious objections. From an economic standpoint, Keynes's line is worth repeating: 'Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation'.[33] Products designed to hedge and minimize risk can themselves become instruments of speculation. From a religious standpoint, markets raise issues of gharar as well as riba. Increasingly however, mainstream Islamic doctrine is reconciling itself to the idea of capital markets, even of certain types of speculative operations, provided that they do not amount to market manipulation. According to one specialist:

> Islam is not against speculation if it is made by genuine investors who have worked hard and analyzed the macro- and micro-economic and financial fundamentals, and therefore have the right to speculate once the environment at the stock exchange is conducive to do so. On the contrary, what Islam is against is insider trading and the role of rumours, whose main interests are to manipulate the market and force their counterparts (the genuine investors) to sell off their shares at lower prices.[34]

The dilemma of emerging markets is that while they lack the institutional experience and attendant financial culture that older financial centres have, they are expected to create, more or less instantly, a transparent and well-managed system that inspires confidence: a market with breadth and depth, with credible national players and regulators, and a state-of-the-art system for placing, processing and settling orders; and a market that cross-lists securities from other regional markets, and that is open to foreign investors. This in itself is a tall order. But even more than laws and institutions, markets require a culture, which cannot be legislated.

9.5 Macro-economic Policies

Banking has a direct impact on money supply – as every economic textbook explains, 'banks create money' – on government borrowing, and on most macro-economic aggregates. Three issues are of special importance: one is regulatory control – how Islamic institutions are regulated and whether they are given special status[35] – which is discussed in Chapter 10. The others are related to the use by governments of the 'interest-rate tool' to regulate the economy, and to the public debt.

The 'interest-rate weapon' is an essential tool of liquidity management, credit allocation, and, more broadly, macro-economic policy. By raising or lowering a variety of rates, regulators can directly influence the money supply. In an interest-free system, such a tool cannot in theory be used. Advocates of Islamic banking argue that other tools can be just as effective. Among such tools are the modification of reserve requirements for banks, the manipulating of budget surpluses or deficits, the imposition of new 'lending ratios' (the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) or 'refinance ratios' (which refer to the central bank refinancing of a part of the interest-free loans provided by the commercial banks).[36] The problem is that such solutions are mostly theoretical constructs, which vastly exaggerate the role of interest-free loans.

In reality however, no Islamic regulatory system has completely eliminated interest. When it comes to relations with the outside world, interest is still used. The three pioneers of full Islamicization – Pakistan, Iran and the Sudan – happen to be heavily indebted countries, whose foreign debt carries interest.

As for domestic borrowing, these countries have not been able to create sufficient Islamic financing instruments to cater for the financial needs of the public sector. A number of theoretical concepts – such as issuing bonds where interest would be replaced by a rate that would vary according to the economy's growth and inflation rate, or mudaraba schemes – have yet to be fully put into practice. One complication is that governments do not have the same criteria of profitability as the private sector, and social rates of return have yet to be operationalized in a way that can satisfy investors.

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10

REGULATORY ISSUES AND CHALLENGES: GLOBAL NORMS AND RELIGIOUS CONSTRAINTS

In the early years of modern Islamic banking, a number of ambitious Islamic regulatory schemes were devised. There was talk of an Islamic Central Bank, of a global zakat fund, and of other collaborative schemes.[1] Scholars worked on an Islamic approach to bank regulation.[2] Most of these ideas were never put into practice: they were simply overtaken by events. Today, regulators have lost the margin of manoeuvre they once enjoyed. Most of the norms and practices of financial regulation are established internationally, with little input from regulators outside the industrial world. Although Islamic banks have thrived in the global economy, their compliance with many of the new norms is problematic. This chapter examines the regulatory issues and challenges facing Islamic finance.

10.1 Financial Regulation

Financial regulators must perform a number of tasks: ensuring that the financial sector is safe and sound; mobilizing savings by channelling them towards the most productive uses; and devising an efficient conduit for payments around the economy. Before the disruptions of the 1970s, regulators performed a mostly technical task outside of the political limelight. In recent years however, virtually every country – including those with well-established regulatory authorities and traditions – has been rocked by banking crises. Significant regulatory failures have occurred in the US (the Savings and Loans and bank failures of the 1980s), Britain (the BCCI scandal, the Barings collapse), and France (the Credit Lyonnais fiasco), to name just a few countries.[3] Emerging markets – the category to which most Islamic countries belong – are even more vulnerable, since they often lack a regulatory framework and tradition, and suffer from a wide array of structural problems. Typically, they are overbanked and in need of consolidation. Many are plagued with a bad loan overhang, and suffer – to an even greater extent than industrial countries – from the 'crony capitalism' syndrome, whereby cosy ties between politicians and bankers prevent effective compliance, let alone reform.[4] Whenever banking crises occur, their impact can be devastating. According to the statistics of

the Bank for International Settlements (BIS), the cost of supporting, recapitalizing or restructuring banks in emerging markets has cost $200 billion between 1982 and 1997.

Once confined to developed countries, the new rules of global finance are now extending to the rest of the world. Four broad sets of factors account for this evolution: the spread of the liberal ideology, the integration of emerging countries in the global economy, the growing involvement of international financial institutions in emerging markets, and the proliferation of currency and banking crises. National and developmental goals were once central to financial policy. But the developmental orthodoxy has changed in line with the 'Washington consensus' which favours free-market solutions, export orientation, fiscal discipline and, most recently, the overhaul of existing financial systems. Indeed, financial turmoil, most recently in Asia, has accelerated the push for bank reform. The IMF and the World Bank have determined that their programmes were undermined by troubled financial sectors; and international banks (as well as pension funds and mutual funds), given their increased exposure to emerging markets, have a lot more at stake than they did a few years ago. New norms are now expected promptly to be adopted by all countries. By October 1998, regulators worldwide were committed to the implementation of the 'Core Principles for Effective Banking Supervision' issued in 1997 by the Basle Committee. Similarly, as of March 1999, the 102 signatories of the December 1997 Free Trade in Financial Services Agreement (under the aegis of the World Trade Organization) were expected to liberalize their markets.

10.2 The Ideological Debates on Financial Regulation

Regulation is a balancing act. Different, often contradictory, goals – flexibility and consistency, freedom and strict controls, innovation and crisis-avoidance, consolidation and conflicts of interest, efficiency and consumer protection, openness and protection of national firms – must be applied in proper dosages by people familiar with the political and cultural environment. The audit systems and incentive structures must be flexible yet strict enough to allow innovation but prevent rogue operations. In case of fraud or heavy losses, the temptation is great to adopt a policy of 'regulatory forbearance' – bending the rules to avoid closing insolvent banks – as a way of preventing panic. But this often leads to distrust and simply postpones the day of reckoning. Yet overreacting can create a credit crunch. Other dilemmas are related to the need to ensure fair competition. The logic of economic freedom in a global economy tends to lead to bigness and thus unfair competition among firms of vastly different sizes. In addition, as firms are allowed to enter new lines of business, the potential exists for conflicts of interest detrimental to the interests of

consumers and investors. For example, as financial institutions get involved in the financial advisory business, the need to sell their products compromises their commitment to impartial advice. Yet building fire-walls between advisory activities and sales goes against the spirit of deregulation.

Such dilemmas are amplified by the transformations of global finance. Once clearly defined, financial functions are now blurred. Different types of finance – commercial banking, investment banking, securities, insurance – call for different forms of regulation. Yet the same financial institution can be a lender, an investor, a guarantor, a portfolio manager, etc. Balance sheets have changed beyond recognition. (Complicating matters further, many transactions do not even appear on balance sheets at all.)[5] In addition, traditional bank products such as loans are being securitized, creating more headaches for regulators who must decide what is a bank, and what types of products need what type of controls. Insofar as financial institutions engage in a wide array of activities, regulators must resolve a number of issues. Should there be functional regulation whereby a financial institution would deal with different regulators for its commercial, investment banking or insurance activities? Or should a financial institution have a single regulator which would oversee diverse functions? In one instance the financial institution would have to comply with complex and perhaps contradictory rules and be entangled in turf battles fought among regulators. In the other, the regulator may lack the expertise to oversee a wide array of activities and may risk being 'captured' by the firms it regulates.

Debates on financial regulation, in addition to being influenced by historical traditions and regulatory cultures, tend to go through cycles and are ideologically loaded. In the wake of financial failures, regulatory authorities are likely to tighten the rules, only to relax them when the memory of such failures fades. Partisans of laissez-faire argue in favour of minimal supervision, claiming that strict supervision does more harm than good and that the 'private provision of bank regulation through the marketplace' is far preferable to intrusive government regulation. The theory is that 'the market' through its proxies – analysts, rating agencies, the business press, etc. – evaluates financial institutions at all times, thus imposing its own discipline on participants. Such an approach also takes a benign view of bank failures, which are seen as a cost of doing business, rather than a cause for panic – or a pretext to tighten regulation. Simply put, the ideological issue can be reduced to a trade-off: laissez-faire fosters financial innovation, but also encourages fraud and abuse; conversely, strict regulation can help prevent problems but stifles innovation and dynamism.

In sum, regulators must thus be strict yet flexible, collegial but not too cosy. The problem is that while lip service is often paid to the principle of independence, regulators not beholden either to politicians or to the

industry they regulate are more an ideal than a reality. In most countries, bankers tend to be prominent figures, often involved in politics, or at the very least generous to politicians. Recent scandals suggest the many ways in which regulators can be influenced. In the case of the American Savings and Loans scandals, dubbed by Martin Mayer 'the worst public scandal in American history', money paid by operators to politicians (in the form of campaign contributions or sweetheart loans) led to bad laws and lax regulation: insolvent institutions were kept in business, fraud and abuse ran rampant, etc. (The bail-out initiated in 1989 will end up costing American taxpayers anywhere between $200 billion and $500 billion.)[6]

An additional problem of regulation is one of resources. The knowledge and skills necessary to be a competent regulator in today's complex, uncertain and constantly changing environment are such that governments can seldom afford the best possible regulators. The private sector in contrast can afford those lawyers, strategists and product innovators who are in a position to keep the industry one step ahead of the regulators.

In Islamic countries, the complications arising from international pressure are compounded by the added – and often conflicting – demands of religion. Religion is a touchy subject, and has on occasion been used as a cover for fraudulent activities. Independence and integrity are all the more important since regulatory issues are even more likely than in a conventional setting to degenerate into major political crises. Furthermore, despite similarities with conventional ones, Islamic products and practices do not fit neatly into existing legal, regulatory and accounting systems. In addition to establishing standard prudential rules (concerning capital and reserve requirements, capital/assets and other ratios), Islamic banking regulators have to devise rules to govern such issues as new finance methods, conditions of ownership of Islamic institutions (minimum capital, maximum individual ownership, etc.), fiscal status of income, and the like. In sum, they must operate under the watchful eyes of 'markets' and religious authorities, while complying with international practices and standards.

10.3 The Changing Paradigm of Financial Regulation: From National Control to Global Supervision

In 1944, John Maynard Keynes, who was then actively involved in shaping the post-war financial order, stated: 'We intend to retain control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements or flights of hot money.'[7] In the system of 'embedded liberalism' that prevailed for much of the post-World War II era, governments were committed to a liberal economic order, but reserved the right to control capital movements.[8]

Under such a system, the regulation of financial institutions was characterized by strict controls, clearly defined boundaries, and limits on foreign participation in the national market. Cartel-like arrangements within sectors prevailed, as well as stable relationships between borrowers and lenders. Financial markets were divided into distinct and clearly defined segments: commercial banks, investment banks, securities firms, insurance companies, etc. Interest rates were 'administered' as opposed to being left to market forces, and most financial operations were tightly regulated. Except for the United States and the United Kingdom, public ownership of banks (by federal or local governments) was common, allowing governments to channel credit to favoured sectors of the economy.[9] Even when banks belonged to the private sector, the logic was not fundamentally different, since government–bank relations were defined by a quid pro quo: managers gave away some autonomy in exchange for protection from outsiders. To be sure, a measure of openness was allowed in many countries, but this did not prevent national firms from remaining somewhat insulated from foreign competition since the occasional authorization given to a foreign firm to operate in the domestic market was designed not to upset existing cartels.

A chain of events, starting with the birth of 'euromarkets', led to a gradual internationalization of financial markets.[10] Change has greatly accelerated in recent years, resulting in a global financial market – which in turn calls for a global regulatory regime.[11] 'Harmonization' of norms is necessary, at a time when capital can move freely, to prevent 'regulatory arbitrage' (the switch by investors and financial institutions to lower-cost regulators). Also, there is a need to create a global 'level-playing field', so that investors and financial institutions from certain countries do not benefit from unfair advantages. Hence the need to agree on common standards and close 'loopholes' such as those provided by offshore financial centres.[12] Another rationale for consolidated global regulation is the fear of contagion. As financial systems are increasingly interconnected,[13] the possibility of problems spreading across the globe are ever-present, raising the spectre of systemic risk – a wholesale collapse of the world's financial system.

The need to contain crises and ensure the integrity of the global system (based on the underlying view that markets should operate fairly and safely in order to encourage the widest possible confidence in them, thereby promoting high levels of savings and investment) explains why, since 1995, financial regulation has taken centre stage in the annual summits of the Group of Seven (G7) heads of government. A succession of financial crises affecting firms – BCCI, Daiwa Bank, Sumitomo, Barings, etc. – or countries – Mexico, Thailand, Indonesia, Korea, Russia, etc. – has lent greater urgency to regulatory cooperation. With each crisis the new orthodoxy has been refined and the reach of global regulators expanded.

The most recent changes in global financial regulation were accelerated by the Asian financial crisis. Until July 1997, the 'tiger economies' of Southeast Asia were held out as models of well-run economies. Reports by the International Monetary Fund and the World Bank praised their macroeconomic management and predicted continuing growth and success. Rating agencies were still awarding high ratings to their debts. The successive crises that spread in domino fashion, starting in Thailand, caught the world by surprise.[14] Since the 'fundamentals' of these economies were sound, a frantic search for new culprits ensued. A new consensus soon emerged, helped in no small part by the steady deterioration of the Japanese banking system: the financial systems of these countries were to blame. Rescues of Thailand, Indonesia and South Korea by the International Monetary Fund (IMF) were directly linked to the transformation of these countries' financial systems, which came to epitomize 'crony capitalism'. Regulators from the developing world, including Islamic countries, now must be trained and counselled on an on-going basis by more experienced regulators. They have little choice, since the acceptance of new norms is the sine qua non to being allowed to expand abroad, or to have access to international financial markets.

10.4 The Making and Enforcement of the New Global Norms

An overlapping network of governments (directly and through the G7 and G10),[15] private corporations (including most large financial banks, securities companies and insurance companies), and international organizations (the World Bank, the International Monetary Fund [IMF], the Organization of Economic Cooperation and Development [OECD], the World Trade Organization [WTO], etc.) has played a key role in promoting global financial standards.[16] This section focuses on two little-known organizations, the Group of Thirty, a private think-tank, and the Bank for International Settlements (BIS), 'the central bank of central banks', both of which were instrumental in shaping the new norms of financial regulation.

The Group of Thirty, established in 1978, describes itself as 'a private, independent, nonpartisan, nonprofit body' whose aims are 'to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and to policymakers'. It is 'supported by contributions from private sources: foundations, banks, non-bank corporations, central banks, and individuals'. In reality it is dominated by the large financial conglomerates, and its role could best be described as that of a consensus-making body on matters of global finance. Through its papers, conferences and symposia, study groups and specialized committees, the Group of Thirty has in recent years

produced the prevailing orthodoxy on matters of capital requirements, harmonization of rules and procedures, derivatives regulation, risk management and cooperation among financial regulators. Because of its make-up, it is the ideal forum for discussions among regulators and practitioners and for consensus-making. Its membership is a who's who of leading financial institutions, central bankers and mainstream economists.[17] It also works in close cooperation with the main trade groups and regulatory associations.[18]

The Bank for International Settlements, created in 1930 and based in Basle, Switzerland, is the oldest international financial organization, and perhaps the most mysterious.[19] The bank is primarily owned by the central banks of industrialized countries. Until recently, the bank's Board was made up of representatives from 11 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States). In 1996–7, it extended its membership to nine emerging countries. Those nine countries, however, are not equal partners: they may join in some discussions, but may not attend G10 meetings unless invited. Yet the BIS has business and advisory relations with considerably more than its shareholding central banks because some 120 central banks and international financial institutions use it as their bank. The total of the currency deposits placed with the BIS amounted to about US$113.1 billion at the end of March 1997, representing around 7 per cent of the world's foreign exchange reserves. Furthermore, the central banks or official monetary institutions of all but a few countries throughout the world are regularly represented at the Annual General Meeting of the BIS each June.

As with other international organizations such as the World Bank and the IMF, the power of the BIS grew with the successive financial crises of the 1980s and 1990s. In 1982 for example, when the debt crisis erupted, the BIS, at the request of the leading central banks and with their support (in the form of guarantees), helped provide bridging finance to a number of central banks, mainly in Latin America and Eastern Europe, pending the disbursement of conditional credits granted by Western governments, the IMF and the World Bank.

Of special interest to us is the Basle Committee on Banking Supervision which was created by the central bank governors of the G10 countries plus Switzerland and Luxembourg in December 1974, in the aftermath of the failures of Franklin National Bank in New York and Bankhaus Herstatt in West Germany. Although formally distinct, the BIS and the Basle Committee are often confused with one another. Indeed, the Secretariat of the Basle Committee is provided by the BIS, and the activities of the two organizations overlap considerably. Under the aegis of the Basle Committee, cooperation among bank supervisors has steadily increased. The first International Conference of Bank Supervisors was held in 1979.

The Basle Concordat of 1975 – revised in 1983 and 1990 – clarified the sharing of supervisory responsibilities among national authorities with respect to banks' foreign establishments, the aim being to ensure effective supervision of banks' activities worldwide.[20] It is by virtue of those rules that bank regulators acted in concert to close down the Bank of Credit and Commerce International (BCCI) in 1991. In 1988 the Basle Committee reached an agreement designed to achieve international convergence in the measurement of the adequacy of banks' capital. The so-called Basle ratios (also known as the Cooke ratios) have been clarified and amended on a number of occasions. In 1997, the Basle Committee issued its 'Core Principles for Effective Banking Supervision'.

In addition to issuing papers and detailed compendia on implementation of sound supervisory standards, the Basle Committee and the BIS have been increasingly involved in the dissemination of global banking norms. There are frequent meetings of central bank economists and other experts on a variety of matters, such as economic and monetary issues of interest to central banks (monetary policy techniques, operating procedures and netting arrangements) and on specialized topics (data bank management, security, automation, internal management procedures, collection of international financial statistics). The BIS also participates with the European Bank for Reconstruction and Development (EBRD), the World Bank, the International Monetary Fund (IMF) and the Organization of Economic Cooperation and Development (OECD) in the 'Joint Vienna Institute', a training institution set up in 1992 to offer courses for central bankers and other economic and financial officials from economies that are 'in transition' from central planning to free markets. In 1998, the BIS announced the creation, in association with the Basle Committee on Banking Supervision, of an Institute for Financial Stability. Its purpose is to organize high-level seminars directed at key policy-making officials in central banks and supervisory agencies, to provide training for the officials in charge of implementation, and to act as a clearing house for the coordination and provision of technical assistance by central banks and supervisory bodies.[21]

A web of global regulation involving banking, securities and insurance regulators has thus taken shape and is continually gaining in size and scope. A number of principles govern this web: home-host cooperation, information sharing, lead regulator principle, transparency, disclosure, etc. How are those norms enforced? Initially, the Basle Committee had no formal authority since its agreements were carried out on a voluntary basis by the member countries. Today, however, it has considerable power due to the new, albeit mostly indirect, powers of enforcement of private, public and international organizations. Adopting certain norms – such as the new capital ratios or the comprehensive home supervision requirement – is now a pre-condition to being part of the global financial system. The

countries whose legislation inspired (in the case of the United States), or were inspired by, the Basle norms would not permit the operation on their territory of banks from countries that did not endorse such rules. Thus, in 1991, in the wake of the BCCI and Banca Nazionale del Lavoro (BNL)[22] scandals, the US Congress enacted the Foreign Bank Supervision Enhancement Act (FBSEA), which added a new layer of control to its regulatory framework. The centrepiece of the legislation was the requirement that a foreign bank show that it is subject to 'comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country' before any application to open a US office, or to significantly expand its business in the US, can be approved.[23] As for the 'Core Principles for Effective Banking Supervision', their implementation is to be monitored by the IMF as part of its regular surveillance procedures. More generally, and especially since an increasing number of countries are now rated by international ratings agencies such as Standard and Poor's and Moody's, any refusal to apply the new norms is likely to result in being sanctioned or even 'ostracized' by the international markets.

10.5 Recent Developments in Global Financial Regulation

This section focuses on three sets of recent developments: the new rules on capital and risk management, the Core Principles for Effective Banking Supervision, and the liberalization of trade in financial services.

10.5.1 Capital Standards and Risk Management

The Basle Accord concluded on 12 July 1988 was a landmark regulatory agreement. For the first time, regulations affecting banks in many different countries were jointly established: banks operating internationally had to have a minimum capital-to-assets ratio of 8 per cent; and the capital was divided into three tiers, each subjected to different definitions and rules.

The idea of imposing strict ratios was related to the banking problems in the United States in the early 1980s, in the wake of deregulation, and as a result of bank exposure to the international debt crisis. In 1984 and 1985, the Federal Reserve Board and the Federal Deposit Insurance Corporation issued new capital guidelines, forcing banks to choose between raising new capital or reducing their assets. The underlying logic was that in order to be able to weather bad economic times, banks needed a high ratio of capital to assets. In January 1987, an agreement between the United States and the United Kingdom extended the principle of uniform rules to the two countries.[24] The ostensible goals were to reduce the risk of the international banking system and to minimize competitive inequality arising from differences among national bank-capital regulations. A more political explanation was that it attempted to eliminate the funding-cost

advantage that had allowed Japanese banks to capture more than one-third of international lending for much of the 1980s.[25] Even before the 1992 deadline, 33 countries besides the Group of 10 had chosen to adopt the 8 per cent rule, arguing that it helped them establish credibility.[26] As of 1998, virtually all countries had officially changed their capital requirements to conform with the Basle ratios.[27] In other words, although aimed initially at banks from the industrialized world that operated internationally, the standards soon became universal. In addition to the 8 per cent rule, the Basle Committee on Banking Supervision devised a risk-based capital framework: different asset classes (both on and off-balance sheet) had to be weighted according to their riskiness. Five weights – 0%, 10%, 20%, 50% and 100% – were attached to different types of assets (cash, OECD and non-OECD government debt, secured and unsecured loans, etc.).[28] Increasingly, following the lead of the United States and the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA), a two-tiered regulation system appeared in many countries: institutions that were well-capitalized would be subjected to a rather light, if not lax, regulatory regime, whereas the others would be subjected to tight controls.

A number of drawbacks appeared over the years, which modifications in the Basle standards attempted to address. Capital requirements moved from being simple mechanical rules to becoming sophisticated risk-adjusted models. For one thing, the world of finance had changed considerably with new financial instruments being devised every day. The Basle ratios concentrated almost exclusively on credit risk, while other risks were ignored. Also, at least in the United States, the financial sector had recovered its health, following a difficult decade (1982–92) and had become more assertive and politically influential.[29] The new paradigm, propounded in particular by the Group of Thirty, became that of 'self-regulation': the largest financial institutions would develop their own risk-management models and tools, and regulators, rather than micro-managing risk, would have to be satisfied that those models were accurate and that internal risk controls and disclosure policies were adequate. In an influential report, the Group of Thirty argued that:

> [T]he fundamental responsibility of ensuring financial stability of financial institutions, and thereby limiting systemic risk, rests with the Board and management of global institutions themselves. It also implies that supervisors will be readier to rely on institutions that they supervise, and that the institutions themselves will accept the responsibility to improve the structure of, and discipline imposed by, their internal control functions.[30]

From 1988, new guidelines on derivatives and off-balance sheet items were issued on a regular basis, as a new orthodoxy on risk management took shape. Each firm had to have a thorough understanding of the risks it

faced. In addition to the credit risk (the risk that a counterparty will fail to perform on an obligation to the institution), other risks had to be covered, with procedures drawn up for each category.[31] As of January 1998, internationally active banks in G10 countries must maintain regulatory capital to cover market risk (the risk to an institution's financial condition, resulting from adverse movements in the level or volatility of market prices of interest rate instruments, equities, commodities and currencies). Market risk is usually measured as the potential gain or loss associated with possible price changes over a specified time horizon. This is typically known as value-at-risk (VAR). Banks must set aside capital to cover the price risks inherent in their trading activities. A standardized measurement framework to calculate market risk for interest rates, equities and currencies is provided, but certain institutions that meet the criteria laid out by the Basle Committee can use their internal models.[32] Other risks include legal risk (the risk of loss because a contract cannot be legally enforced, for example because of insufficient documentation or insufficient authority of the counterparty), liquidity risk (the possibility that the firm may not be able to fund its financial-trading activities or to resell its products on the secondary market), and operational risk (the risk of unexpected losses due to deficiencies in information systems or internal controls, which may be caused by human error, system failure or inadequate procedures and controls).

The new regulatory framework thus focuses on an institution's risk control strategy, with risk control defined as the entire process of policies, procedures and systems an institution needs to manage prudently all the risks resulting from its financial transactions, and to ensure that they are within the bank's risk appetite. To avoid conflicts of interests, risk control had to be separated from and sufficiently independent of the business units which execute the firm's financial transactions.

In order to comply with the new rules, most firms devised checklists: who formulates the firm's guidelines and policies? What type of financial instruments may the firm use? Are the products and their implications understood by all concerned? How are the financial instruments valued? Is there a limit system in place? What are the major risks resulting from financial instruments? How is the information communicated to managers and shareholders? Firms also devised lists of approved financial instruments, where each instrument would be clearly described together with an analysis of its usefulness in relation to other activities and the firm's financial condition, as well as reasons for its use. A continuum of financial instruments distinguishes between non-derivative (cash instruments such as fixed-rate bonds), plain vanilla derivatives (such as currency swaps), exotic products (more complex instruments such as lookback options), hybrids (for example, fixed-rate bonds with options embedded in them) and leveraged derivative products (a specific type of derivative financial

instrument containing formulas or multipliers, which for any given change in market prices, could cause the change in the product's fair value to be several times what it would otherwise be). In every instance the amount at risk would be different. With traditional instruments such as loans, bonds or foreign exchange, the amount which the counterparty is obliged to repay is the full or principal amount of the instrument. In the case of derivatives, the risk is not equal to the principal amount of the trade, but rather to the cost of replacing the contract if the counterparty defaults. This replacement value fluctuates over time and is made up of current replacement and potential replacement costs.

Ironically, less than a year after the rules came into effect, the hedge-fund debacle of the summer of 1998 showed that the much-vaunted risk models of large financial institutions were woefully inadequate.[33]

10.5.2 The Core Principles of Bank Supervision

In 1992, the first minimum standards for cross-border supervision established four main principles: (1) All international banks should be supervised by a home country that is capable of performing consolidated supervision; (2) The creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authority; (3) Home country authorities should possess the right to gather information from their cross-border banking establishments; (4) If the host country determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

With the proliferation of banking crises worldwide, the G7 pressed the Basle Committee to issue more detailed guidelines. Indeed, from 1995, G7 summit communiqués had repeatedly called for measures to strengthen banking regulation and supervision, in particular deeper cooperation among supervisors of global firms to 'promote the development of globally-integrated safeguards, standards, transparency and systems necessary to monitor and contain risks', and improved supervision in the emerging market economies.

In 1997, the Basle Committee issued for comment a draft of its '25 Core Principles for Effective Banking Supervision'. Among those principles are the following: all banks must have comprehensive risk-management systems as well as management information systems that enable management to identify concentrations within their portfolio; supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers; they must also determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or

unintentionally, by criminal elements; and regulators must be able to supervise the banking group on a worldwide consolidated basis.

According to the press release, the Principles 'were drawn up by the Basle Committee in close collaboration with the supervisory authorities in fifteen emerging market countries and have benefited from broad consultation with many other supervisory authorities throughout the world'. They were 'intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdictions'. Supervisory authorities throughout the world were 'invited to endorse the Core Principles, not later than October 1998'. The Principles were designed to be verifiable by national regulators, regional supervisory groups and the market at large. The Basle Committee would monitor the progress made by individual countries in implementing the Principles. In addition, the International Monetary Fund, the World Bank and other international organizations were asked to use the Principles 'in assisting individual countries to strengthen their supervisory arrangements in connection with their work aimed at promoting overall macroeconomic and financial stability'. The Basle Committee also announced it was preparing a three-volume Compendium of its existing recommendations, guidelines and standards.

As of October 1998, emerging countries were expected to review their current supervisory arrangements and set a timetable to make changes in order to conform with the Principles. If legislative changes were needed, national legislators were requested to give urgent consideration to the changes necessary to ensure the application of the Principles. Some in the banking profession have criticized those Principles for being too vague – in effect, for being guidelines and not strict rules. The Principles, say other critics, pay insufficient attention to several issues, such as the profitability, the quality of deposits (which is especially important in emerging markets) and earnings.[34] Implementation of the Principles was to be reviewed at the International Conference of Banking Supervisors in October 1998 and biennially thereafter.

10.5.3 Free Trade in Services

Financial services were left out of the Uruguay Round Agreement that created the World Trade Organization in 1994. At the time, countries such as South Korea, India and Brazil feared that an onslaught of foreign competition would endanger their national firms. This unfinished business was taken up by the newly created organization. In 1995, an agreement was arrived at, but was rejected by the United States on the grounds that it did not go far enough in the direction of liberalization. For a time, the talks seemed deadlocked. It is in part as a result of the Asian financial crisis of 1997 that the deadlock over the financial services agreement was broken. By

the end of that year, Asian countries had lost much of their bargaining power as they desperately needed the help of Western governments and international organizations such as the IMF.[35] And the US and other developed countries, worried about the ripple effects of the crisis, were intent on drastic reform. In their view, the fastest way to cure a sick financial system and to reform it is to open it to foreign competition. In the words of US Deputy Treasury Secretary, Lawrence Summers: 'Emerging markets' growing importance to the global economy gives the international community a particularly strong interest in strengthening their financial systems to insure against financial-sector crises like the one in Thailand'.[36]

In December 1997, an agreement was finally signed, with 102 countries pledging to open, to varying degrees, their banking, insurance and securities sectors to foreign competition. The agreement, effective as of March 1999, covers 95 per cent of the world's multi-trillion dollar financial services – which according to US negotiators involves $18,000 billion in global securities assets, $38,000 billion in international bank lending and $2,500 billion in worldwide insurance premiums. Like other World Trade Organization agreements, the financial services agreement covers not just cross-border trade but all the ways foreign suppliers can deliver services to a country's market, including the establishment of local subsidiaries and branches. The interests of foreign firms were to be protected by the rules of the world-trade body.[37]

The WTO stressed the benefits of the new agreement to developing countries. Increased international competition in financial services would force domestic companies to reduce waste, cut costs, improve management and become more efficient. Liberalization would improve service quality, and benefit consumers, depositors and investors. Open markets would encourage the emergence of new financial instruments, allowing companies to choose the optimal combination of equity, loans or commercial paper to finance their activities. In addition, according to the WTO, broadening the volume of transactions and the spectrum of services would reduce the volatility of markets and their vulnerability to external shocks.[38]

10.6 Applying the New Norms in the Islamic World

While elaborating the '25 Core Principles for Effective Banking Supervision', the Basle Committee negotiators initially considered having two sets of principles, to be applied respectively to developed countries and developing ones. In the end however, they settled for a single set of rules that would be applicable worldwide. As this section shows, most Islamic countries are ill-prepared to implement these reforms. Only two Islamic countries – Malaysia and Indonesia – were nominally associated with the

work of the Basle committee,[39] and both have since had their differences with the global financial community. At the time of the Asian financial crisis of 1997, both countries saw themselves as victims of speculative financial flows. Indonesia only reluctantly accepted the conditions imposed by the IMF in exchange for its rescue package. Malaysia, in the WTO negotiations, fought vigorously in favour of maintaining limits on foreign ownership of some of its financial firms. Indeed, one of the last-minute stumbling blocks concerned the new 30 per cent limit on foreign ownership of insurance firms as part of the 'Malaysianization' programme.[40] After the signing of the agreement, the conflict between Malaysia and the international financial community escalated. Prime Minister Mahathir blamed international speculators for the country's woes. In September 1998, Malaysia took drastic steps to insulate itself from the vagaries of the international markets. Still, Islamic countries are expected to comply with many of the new norms of global banking, despite institutional, cultural, political and religious obstacles.

Although most Islamic techniques have conventional counterparts, they do not always fit conveniently within existing regulatory regimes. The main financing techniques often imply specific contractual obligations and different levels of risk than their conventional counterparts.[41] From the standpoint of Islamic bankers, Islamic financial techniques are fundamentally different from conventional loans, and they should therefore not be subjected to the same prudential ratios and capital requirements as conventional banks.[42] The attitude of many Western regulators can be summed up in a famous statement by Robin Leigh-Pemberton, former governor of the Bank of England, to the effect that Islamic banking is 'a perfectly acceptable mode of investment, but it does not fall within the long-established and well understood definition of what constitutes banking in this country'.[43]

From the standpoint of ownership and control, many such banks cannot comply with the 'comprehensive consolidated supervision by the home country regulator' requirements. Indeed, the majority of Islamic financial institutions belong to, or are otherwise associated with, transnational groups such as Dar Al-Maal Al-Islami (DMI) or the Dallah Al-Baraka group. DMI, controlled by Prince Mohammed al-Faisal al-Saud, is headquartered in the Bahamas and runs its network of banks out of Geneva. Commercial operations extend throughout the Islamic world though not in Saudi Arabia. Similarly, the Dallah Al-Baraka group is controlled by Saleh Kamel, a Saudi citizen, but does not operate a bank in his home country. Ever since the collapse of the Bank of Credit and Commerce International (BCCI), which had used loopholes within the global regulatory system to engage in illegal practices, regulators have frowned upon such structures. In 1993, the Bank of England ordered the closure of Al-Baraka International Bank, the British subsidiary of the Dallah Al-Baraka Group,

on the grounds that the bank's true 'mind and management' were in Saudi Arabia although it did not operate as a bank there.[44]

Another set of issues faced by Islamic financial institutions is the new emphasis on internal risk management. Because of the religious injunctions against gharar,[45] financial institutions and their Shariah boards tread carefully around all issues involving risk,[46] including complicated financial instruments designed to control risk. Thus, although such products are supposed to control risk and reduce it (although as we saw, they sometimes have the opposite effect), they do not always pass muster with Shariah boards. Islamic banks have thus been lagging in their efforts to devise the risk management techniques required by regulators.

Other regulatory complications are posed by the nature of interest-free banking. In the United States for example, Islamic financial institutions have found it hard to comply with the Truth-in-Lending Act, the federal regulation that governs full disclosure of terms and costs in lending transactions. The law requires the use of the term 'annual percentage rate'. Even replacing it, as some have suggested, by a 'profit participation rate' would be tricky since it would mean the endorsement of the 'fixed, predetermined rate' concept to which many Islamic scholars object.

One of the flaws of the principle of global and compulsory norms is that it ignores the fact that banking structures are embedded within a religious, institutional, political and cultural context that cannot, international prodding notwithstanding, be changed overnight. Consider for example the new norms of banking supervision: arms'-length relations between banks and their customers, 'know-your-customer' rules,[47] limits on sizable exposure to a single client or to a group of connected clients; disclosure and transparency, etc. It is unrealistic to expect the successful implementation of such principles in countries where the business community is small and enjoys close ties with the political elite.

Matters of disclosure and transparency also have a cultural dimension. The openness with which Americans discuss financial matters – such an executive's salary or an individual's net worth – contrasts sharply with the way such matters are discussed (or the fact that they are not discussed at all) in other cultures. The opacity extends to issues such as bank ownership, where the use of 'fronts' is common and does not necessarily imply sinister intent. In the first high-profile instance of application of the 1991 Foreign Bank Supervision and Enhancement Act (FBSEA), Saudi Arabia's National Commercial Bank, the largest bank in the Middle East, was accused of helping the Bank of Credit and Commerce International conceal its ownership and financial condition, and was ordered by the Federal Reserve Board to close its New York branch. In a compromise, it eventually chose a 'voluntary liquidation', and a $170 million penalty was levied against its former head, Sheikh Khalid Bin Mahfouz.[48] His attorney Laurence Tribe, the Harvard University constitutional law expert, undertook to

rehabilitate him by arguing that the case highlighted a lack of cross-cultural understanding and an international financial and regulatory system more adapted to pursuing and controlling corruption than to defending individual rights.[49]

10.7 The Supervision of Islamic Financial Institutions

10.7.1 Prudential Regulation

Left to its own devices, the financial industry is prone to various excesses and types of fraud. These in turn undermine confidence and can shake the economy to its foundations.[50] A central function of the regulators is 'prudential' – making sure that financial institutions operate in a prudent manner. Confidence is instilled by establishing the right safeguards and enforcing strict supervision. A number of monitoring mechanisms – prudential ratios, accounting, auditing and disclosure rules – are available and have far-reaching implications. The sudden liberalization of finance has revealed the predicament of regulators. On the one hand, they are dedicated to a free market and strive to encourage financial dynamism and innovation. But on the other hand, a free-wheeling climate is highly conducive to fraud, in particular to speculative bubbles and 'pyramid' schemes – whereby institutions pay dividends from new deposits, rather than from profits generated by legitimate business operations. In Egypt in the 1980s, billions of dollars 'evaporated' and the fact that the IMMCs operated under the veil of Islam was particularly damaging.[51]

Islamic financial institutions present special problems. Due to the lack of suitable Islamic investments, many banks have been prone to placing their excess liquidity in risky places. Insofar as they do not usually purchase Treasury Bonds, and frequently place their assets overseas, regulators are often unable to properly monitor the bank. Another potential problem has to do with profit-sharing ratios and the bank's relation to its depositors. Typically, 70 per cent of these profits go to depositors and 30 per cent to bank owners, but at times of low profits, banks sometimes choose to subsidize profit distributions to depositors out of the bank owners' share of profits, which is clearly unsustainable in the long run.[52]

10.7.2 The Question of Dual Regulation

Countries having a dual – conventional and Islamic – financial system must contend with a dilemma: should both types of banks be subjected to the same rules and regulations (on capital adequacy ratios, liquidity provisions, depository reserves, accounting and auditing standards, etc.)? And should they be supervised by the same supervisory authorities? Given the current emphasis among international regulators on comprehensive regulation, a

strong case can be made in favour of a single regulator that would be in a position to see the 'big picture' of the financial system. Regulators may not accomplish their mission if a whole segment of the industry is beyond their reach.

Most Islamic banks however favour separate treatment. Their argument can be divided into two parts: a religious argument, based on the belief that religious factors should be paramount; and an economic argument, to the effect that Islamic operations are fundamentally different from conventional ones. It is unfair, in their view, to treat the main Islamic financing techniques – mudaraba, musharaka and murabaha – as conventional loans since many such operations do not constitute lending, but merely financing, or even sales. Also, as they lobby in favour of special treatment, Islamic banks argue that only by being treated separately could they be in a position to develop their identity and in turn create new products.

A related issue is that of discrimination – whether positive or negative. Conventional banks have repeatedly decried the 'special privileges' enjoyed by their Islamic counterparts, which in their view amount to unfair competition. Conversely, at times Islamic institutions have complained about not having the same prerogatives as their conventional competitors. Consider for example the case of Faisal Islamic Bank of Egypt. Created in 1977 by a special law, it was given countless privileges that went far beyond the already considerable advantages provided to foreign investors by 1974 (Law Number 43). The new bank was exempted from foreign exchange controls, corporation regulations, credit control (except for credits in local currency), labour laws and social legislation, and customs duties. Also, for a period of 15 years, it would not be subject to income, corporate or real estate taxes. It was further given ironclad guarantees against nationalization or seizure of deposits. And it was placed above the law since any conflict between the bank and any other party would be resolved solely by the bank's board of directors. Such an array of privileges (some of which were later rescinded) led to accusations that the bank would become a 'state within the state'.[53]

Similar criticisms were levelled at Turkish 'Special Finance Houses'[54] which were, from their inception, subjected to lower reserve requirements than their conventional counterparts.[55] In 1996, during the rule of Islamist Prime Minister Necmettin Erbakan, the six Islamic institutions were given a further boost when their performance bonds were deemed acceptable in state tenders. At the same time however, Islamic institutions were arguing that they were in fact the ones discriminated against. As proof that they were victimized by a political vendetta led by the military-dominated political establishment, they put forth the following evidence: the authorities had made it nearly impossible for them to expand their branch network; an earlier increase in reserve requirements had already slowed down the flow of deposits; and they were more thoroughly inspected by the Treasury and

the Central Bank than the conventional banks.[56] But soon after the Islamic Prime Minister was forced to resign in 1997, new legislation brought Islamic financial institutions under the jurisdiction of the banking law.

Worldwide, the current trend in bank regulation and central banking is towards 'independence', meaning that regulators ought to be technocrats insulated from political pressures. A case can be made that such insulation is more difficult to achieve in the case of Islamic banks, as regulatory considerations are more likely to be overridden by political, and of course religious, considerations. Another issue is that of experience. The regulation of Islamic financial institutions requires an understanding of both Islamic and conventional finance. If anything, the novelty of Islamic financial products calls for greater vigilance, especially as rapid growth and competitive pressures are likely to lead financial institutions to take on greater risks.

Within the Islamic world, the dilemma of dual regulation has generally been resolved in one of two ways: by establishing, within the central bank, a division dealing with Islamic banking, or by coordinating the supervision of the respective banks. Bahrain has chosen the first path: the Bahrain Monetary Authority has its own Shariah advisers who oversee matters of concern to Islamic institutions. In Kuwait, on the other hand, the regulation of Islamic institutions (the International Investor and the Kuwait Finance House) is conducted not by the Central Bank but by the Finance Ministry, although both types of banks are subjected in practice to the same general rules. The Central Bank and the Finance Ministry coordinate their supervision, and there is an implicit understanding that, should the Islamic institutions run into difficulties, they would receive the same kind of support as conventional banks.

10.7.3 Deposit Insurance and the Lender of Last Resort Issue

Another unresolved issue is that of deposit insurance. In most countries, if a bank fails, a government agency, drawing on a special fund, steps in to reimburse depositors. The underlying philosophy is that certain types of deposits and certain groups of people deserve to be protected – in effect insulated from the ups and downs of the economic cycle. In the United States, deposits are insured by the Federal Deposit Insurance Corporation (FDIC), up to $100,000. Customers, in exchange for the protection, accept a lower remuneration. Banks pay a premium and agree to strict controls by the FDIC.

Insofar as Islamic banking is supposed to be primarily based on profit-and-loss sharing, deposit insurance should not normally apply. Depositors are shareholders of sorts, whose fortunes are tied to the institution's fate (or to the fate of the specific investment being financed). Only if the institution (or the investment being financed) makes a profit will they be

entitled to a share of the profit. Potential losses carry a heavy political and economic cost. Typically, the government is likely to step in. No consensus exists among Islamic banks which are caught in a dilemma: the logic of PLS accounts does not lend itself to deposit insurance; yet human psychology is such that depositors want to have it both ways – sharing in the profits and being insured against losses. The absence of a 'fixed, predetermined' interest rate complicates the determination of premiums, and of course such protection has the unfortunate consequence of discouraging the typically Islamic profit-and-loss sharing accounts in favour of conventional demand deposit ones.

In reality, the share of PLS transactions has been very low.[57] On a number of occasions, Islamic banks (and thus indirectly their depositors) had to be rescued, usually as a result of losses on commodities and foreign exchange markets and sometimes as a result of fraud. In most instances, there was one of three outcomes (or a combination thereof): temporary takeover by the Central Bank (it happened temporarily for Egypt's International Islamic Bank for Investment and Development [IIBID]), injection of funds from the government (it happened in 1984 with the Kuwait Finance House), or emergency funds from consortia of Islamic banks, usually led by the Islamic Development Bank (IDB) (it happened with the Dubai Islamic Bank in 1998).

There is everywhere, therefore, at least implicitly, some deposit insurance scheme and a lender of last resort. When South Africa's Islamic Bank Limited was recently liquidated, the South African Reserve Bank announced that, although the country does not have deposit insurance protection, it would compensate all depositors up to 50,000 rand ($11,000) each. The decision was taken 'in the interest of financial stability of the country'. The announcement also stated that '[t]his arrangement should not be seen as creating a precedent'.[58]

Such a caveat was to be a reminder that expecting bail-outs can lead to reckless behaviour – one example of the all-pervasive moral hazard, which extends to many aspects of financial supervision. The concept, which originated in the insurance industry, is that certain rules and practices tend to encourage reckless behaviour. For example, once a business has obtained fire insurance, it may be inclined to reduce its expenditures on fire safeguards and prevention, thus increasing the likelihood of a fire as well as the size of the losses that the insurer may incur.[59] By the same token, insured depositors care little about the financial health of their bank, while unscrupulous financial operators may be invited to gamble with the public's money. For a slightly higher interest rate on insured deposits, a weak or even insolvent financial institution can obtain almost unlimited funds.[60] A similar incentive to engage in risky behaviour occurs when management operates without substantial net worth or stockholder capital. Indeed, US legislation aimed at allowing S&Ls (Savings and Loans) to

diversify their investments beyond financing home purchases, combined with lax supervision and an increase in the insured deposit amounts, turned out to be an invitation to gamble with the insured public's money through real-estate speculation or junk bonds.[61]

By the same token, announcing that the government will be a lender of last resort can encourage risky behaviour. In most instances, there is an implicit 'too big to fail' policy – an unspoken guarantee against failure given to the largest institutions for fear of either run contagion or a gridlock shutdown of the payment or banking system. The predicament of regulators in a free-enterprise system is that they must act as if such a safety net did not exist – or else they would invite customers of small banks to transfer their deposits to largest banks – yet be ready to rescue those institutions whose collapse is likely to trigger a domino effect.[62]

A related question is that of the resources of a central bank in an interest-free setting. Assuming no deposit insurance scheme, where would the resources of the central bank come from? One suggestion was that Islamic Central Bank acquire some equity in the commercial banking sector, giving it access to the resources necessary for it to act as lender of last resort.[63]

10.8 Conclusion

In the early years of Islamic finance, national regulators enjoyed wide autonomy. Islamic regulators could devise rules and practices with minimum interference from the outside world. This chapter has explained why this is no longer the case. Today, they are urged to comply with new international rules, as well as to liberalize and open up their financial sector to foreign competition. Islamic regulators thus face a daunting task to which they are singularly ill-prepared: they must engage in consolidation and reform in the face of considerable obstacles before domestic banks confront the onslaught of foreign competition. As one analyst remarked:

> The terrible truth is that supervisors in developing countries, capable and well intentioned though they may be, typically lack the resources, independence and clout to do their jobs properly. As a result, the banks in their care are often able to expand recklessly, lend carelessly and run themselves unwisely. To make things worse, supervisors sometimes come under pressures to turn a blind eye to the imprudent practices of some bankers.[64]

At a time of harmonization of regulatory practices, the interest-free Islamic regulators have a hard time achieving convergence with interest-based conventional regulators. Interest rates have been an essential (and convenient) tool of regulation and control. By raising or lowering a variety of rates, regulators can influence the money supply and achieve specific

policy goals. In an interest-free system, such a tool cannot in theory be used. Advocates of Islamic banking argue that other tools can be used – such as modifying reserve requirements for banks, injecting liquidity into the system (for example by manipulating surpluses or deficits), or imposing new 'lending ratios' (the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) or 'refinance ratios' (the central bank refinancing of a part of the interest-free loans provided by the commercial banks).[65] Original solutions have been offered to deal with issues such as deposit insurance or the ability to be lenders of last resort.[66] It remains to be seen how such schemes can fit with new approaches to bank regulation as promulgated by the Basle Committee, or be 'harmonized' with the prevailing practices of other regulators.

The main problem with one-size-fits-all approaches is that they ignore the fact that different countries have different institutional frameworks and regulatory cultures. To be sure, there are a number of escape clauses,[67] and the makers of the new global norms usually pay lip service to the notion that differences across regulatory systems should be part of rule-making. Clearly, the timetables and expectations of the new global regulations are unrealistic. It remains that, given the firm deadlines associated with the implementation of the 'Core Principles' and the WTO Agreement, and given the various surveillance and enforcement mechanisms discussed earlier, there is little doubt that the new norms – openness and transparency, free flow of capital, internal controls, better informed and more consistent supervision – will define, if not the extent of change, at least its direction. As countries build legal and regulatory infrastructures – especially in regard to nascent stock and financial markets – they will be bound by the new rules.

Notes

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2. Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics 1982.
3. Ibrahim Warde, 'Financiers flamboyants, contribuables brûlés', *Le Monde diplomatique*, July 1994.
4. Ibrahim Warde, 'Regulatory Cultures', IBPC Working Papers 1998.
5. Itzhak Swary and Barry Topf, *Global Financial Deregulation: Commercial Banking at the Crossroads*, Oxford: Blackwell 1992.
6. Kathleen Day, *S&L Hell: The People and the Politics Behind the $1 Trillion Savings and Loan Scandal*, Norton 1993; Martin Mayer, *The Greatest-Ever Bank Robbery*, Scribner's 1991.
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8. John Gerard Ruggie, 'International regimes, transactions, and change: embedded liberalism in the postwar economic order', in Stephen D. Krasner (ed.), *International Regimes*, Cornell University Press 1983.

9. John Zysman, *Governments, Markets and Growth*, Cornell University Press 1983.
10. Susan Strange, *Casino Capitalism*, Manchester University Press 1997.
11. See Chapter 5.
12. Claude E. Barfield (ed.), *International Financial Markets: Harmonization versus Competition*, Washington: The American Enterprise Institute Press 1996.
13. François Chesnais, *La mondialisation financière: Genèse, coût et enjeux*, Paris: Syros 1996.
14. Ibrahim Warde, 'Les remèdes absurdes du Fonds monétaire international', *Le Monde diplomatique*, February 1998.
15. The G7 and the G10 refer respectively to the seven and the 10 most industrialized countries. The G7 should more accurately be called the G8 since it now formally includes Russia.
16. Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State*, Harvard University Press 1994.
17. In 1998, its chairman was Paul Volcker, the former Chairman of the Federal Reserve Board, and its members included prominent international regulators (including Andrew D. Crockett, General Manager of the Bank for International Settlements, Jean-Claude Trichet, Governor of the Banque de France, and Jacob A. Frenkel, Governor of the Bank of Israel), major financial firms (such as Morgan Stanley, Merrill Lynch and Dresdner Bank) and leading economists (such as Princeton's Peter Kenen and the Massachusetts Institute of Technology's Paul Krugman).
18. Based on a variety of Group of Thirty publications, and on information from its website.
19. It was initially created upon the adoption of the Young Plan, which was designed to settle the problem of German reparations after World War I, at the Hague Agreements of 20 January 1930. Initially, it was owned by six European central banks and an American financial institution. The United States, although an active participant, did not formally become a shareholder until 1994. The history of the bank has left it many quirks: although owned by central banks, its shares are trades on stock exchanges in Paris and Zurich; its also has its own 'currency', the gold franc.
20. Miroslava Filipovic, *Governments, Banks and Global Capital: Securities Markets in Global Politics*, Aldershot: Ashgate 1997, p. 175.
21. Based on publications, press releases and the website of the Bank for International Settlements.
22. The Atlanta (Georgia) branch of the Banca Nazionale del Lavoro had made illegal loans to the Iraqi government.
23. Raj K. Bhala, *Foreign Bank Regulation after BCCI*, Durham, N.C.: Carolina Academic Press 1994.
24. Filipovic, p. 180.
25. John D. Wagster, 'Impact of the 1988 Basle Accord on International Banks', *Journal of Finance*, September 1996.
26. *Global Finance*, November 1992.
27. Ibrahim Warde, *The Regulation of Foreign Banking in the United States*, San Francisco: IBPC 1998.
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30. The Group of Thirty, 'Global Institutions, National Supervision and Systemic Risk', Washington 1997.

31. John C. Braddock, *Derivatives Demystified: Using Structured Financial Products*, New York: Wiley 1997; Lillian Chew, *Managing Derivative Risks: The Use and Abuse of Leverage*, New York: Wiley 1996.
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34. David Fairlamb, 'Beyond capital adequacy', *Institutional Investor*, August 1997.
35. *The Wall Street Journal*, 15 December 1997.
36. *Far Eastern Economic Review*, 2 October 1997.
37. *Financial Times*, 15 December 1998.
38. *Far Eastern Economic Review*, 2 October 1997.
39. The countries outside the G10 are Chile, China, the Czech Republic, Mexico, Russia and Thailand, Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore.
40. *The Wall Street Journal*, 10 December 1997.
41. See Chapter 7.
42. Chibli Mallat, *Islamic Law and Finance*, London: Graham and Trotman 1988.
43. *Financial Times*, 28 November 1995.
44. *Financial Times*, 3–4 April 1993.
45. Chapter 3.
46. Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, gharar and Islamic banking*, Cambridge University Press 1986.
47. The 'know-your-customer' rule is primarily designed to make sure that the bank is not a conduit for illicit funds, such as those obtained from money laundering. Banks are expected to report suspicious transactions to regulators.
48. Ibrahim Warde, *Foreign Banking in the United States*, San Francisco: IBPC 1999.
49. *Financial Times*, 10 January 1995.
50. See the episodes described in James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken*, New York: Farrar, Straus Giroux 1992, and John Kenneth Galbraith, *A Short History of Financial Euphoria*, New York: Viking 1990.
51. See Chapter 4.
52. Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk, and Return*, The Hague: Kluwer Law International 1998, p. 8.
53. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*, Paris: Presses universitaires de France 1997, p. 57.
54. Turkish legislation did not allow the use of the word Islamic in either the name of the financial institution or the description of their operations.
55. Conventional banks must keep 8 per cent of all deposits and 11 per cent of all foreign exchange with the Central Bank. Islamic houses must keep 10 per cent of their current accounts held before June 1994 in cash and another 10 per cent with the Central Bank, among other requirements. *The Wall Street Journal*, 8 January 1998.
56. *The Wall Street Journal*, 8 January 1998.
57. See Chapter 7.
58. Agence France-Presse, 21 November 1997.
59. Kenneth E. Scott and Barry R. Weingast, *Banking Reform: Economic Propellants, Political Impediments*, Stanford: Hoover Institution Press 1992, p. 2.
60. Scott and Weingast, p. 3.
61. Michael Lewis, *Liar's Poker: Rising Through the Wreckage on Wall Street*, 1989, p. 218.
62. Scott and Weingast, pp. 8–9.

63. Mohammed Uzair, 'Central banking operations in an interest-free banking system', in Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, 1982.
64. Fairlamb, August 1997.
65. See Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, 1982, especially Mohammed Ariff, 'Monetary policy in an interest-free Islamic economy – nature and scope'; Mohammed Uzair, 'Central banking operations in an interest-free banking system'; and Mohammed Siddiqi, 'Islamic approaches to money, banking and monetary policy: A review'.
66. Uzair, 'Central banking operations …', in Ariff (ed.).
67. Article 21 of the World Trade Agreement (WTO), for example, allows members to take trade actions to protect their 'essential security interests'.

11

ISLAMIC FINANCE AND POLITICS: GUILT BY ASSOCIATION

Any sweeping generalization about political Islam is likely to be misleading, if not downright wrong. Different, contradictory strands have co-existed at all times. One can find numerous examples of Islam as an ideology of protest against social injustice and a means to defend the rights of the disinherited and oppressed, or of Islam as the religion of the establishment, used to justify the status quo, or as an entirely non-political ideology.

A complicating factor is that relationships between religion and politics are fluid, dynamic, and dependent on contingent factors as well as external events. While it is easy to think of a government's relations with Islamist groups in terms of simple dichotomies – opposition/loyalism, co-optation/repression, etc. – the reality is more complex. Governments often apply successively, and sometimes simultaneously, contradictory policies. At times, governments fight Islam with Islam, co-opting Islamist groups as a way of keeping them under control. A complicating factor is that such policies often backfire. When the otherwise secular Zulficar Ali Bhutto tried to exploit Islam, he became all the more vulnerable to Islamic opposition groups and their charges of hypocrisy.[1] Similarly, Anwar Sadat carefully cultivated his image of 'believer-president' and patron of Islam. In conjunction with his overtures towards the Muslim Brothers, he amended Article 2 of the Constitution in 1971 and then again in 1980 – at a time when he was aggressively fighting Islamic fundamentalists – to proclaim that 'the Islamic Shariah is the principal source of the Constitution'. This did not prevent extremist groups from launching a 'jihad' against him, and from assassinating him in 1981.[2]

Opinions differ as to the political impact of Islamic finance. Some see in it a 'democratizing' and a 'moderating' factor, arguing that by legitimating certain forms of modern business, it may strengthen civil society against the arbitrary rule.[3] In the words of Clement Henry:

> While Islamic bankers do not necessarily share any commitment to Western-style liberalism or democracy, their drive for markets and profits may indirectly contribute to a more competitive politics. Their economic success sets the stage for greater democracy by encouraging popular participation in financial activities, by shifting the

> political weight within popular Islamist movements in favor of 'responsible' business elements ready to coexist with the capitalist order, and by accumulating finance capital, helping to consolidate the structural power of the commercial banking system and the autonomy of the private business sector.'[4]

As noted earlier, banks, by virtue of being part of the existing power structure, have a strong status quo orientation. There are however exceptions to that general rule. And as the next pages show, the benign view is not widely shared among authoritarian leaders who often see financial Islam as a destabilizing force.

This chapter addresses the connection between Islamic finance and politics in domestic and international contexts. Following a general discussion of the relation of money and politics, it compares the evolution of financial Islam in Saudi Arabia, Iran, Turkey, Egypt, the Sudan and Indonesia. It later discusses the role of Islamic finance in the New World Order, arguing that Islamic financial institutions are all too often 'guilty by association'.

11.1 Business, Finance and Politics

The connection between money and politics is well-established. One can think of the old saying that 'money is the sinew of war', or of California politician Jesse Unruh's famous dictum that 'money is the mother's milk of politics', or of the advice given by mysterious informant 'Deep Throat' to the journalists investigating the Watergate affair: 'Follow the money'. No wonder Islamic financial institutions have on occasion been suspected of having a political agenda, domestically – working to establish a fundamentalist Islamic regime – or internationally – financing or serving as a conduit for 'international Islamic terrorism', or even for the development of an 'Islamic bomb'.

Such claims, casually if sometimes hysterically made, have seldom been subjected to systematic scrutiny. It is important to distinguish what has been inadvertent from what was intended, and what is exceptional from what is the norm. Thus, it is probably true that the Islamic banks of the Sudan facilitated the advent of an Islamic state in that country. The significant issues are, first, whether it was the intended outcome of the creation of the Faisal Islamic Bank, and second, whether such a scenario is likely to be replicated elsewhere.

Also, on occasion, Islamic financial institutions have been suspected of involvement in subversive activities. The most frequently cited example is that of the 'Afghan warriors'. Generously funded by Saudi Arabia and trained and organized by the US Central Intelligence Agency (CIA), a number of volunteers from Islamic countries fought, along with Afghan Mujahideen, the Soviet forces in Afghanistan throughout the 1980s. The

support was part and parcel of the Saudi effort to promote Islam worldwide by funnelling aid, sometimes via Islamic banking networks, to a wide variety of Islamist groups, some of which turned out to be, or became, radical and subversive.

Helping the Mujahideen was part of the US-led effort to overthrow the Communist regime of Kabul. Both Saudi Arabia and Pakistan, two 'fundamentalist' yet pro-US countries, played an active part in that effort. Unwittingly, the resistance movement sowed the seeds of a transnational anti-US and anti-Saudi political movement. Indeed, with the Soviet withdrawal, some of the non-Afghan Islamic volunteers – the so-called 'Afghan Arabs' – found themselves in the position of hardened rebels without a cause, and ended up involved in a number of terrorist actions. The irony of course is that such attacks, which include anti-tourist attacks in Egypt, the bombing of the World Trade Center in New York in 1993, the Khobar Attack on US Marine barracks in Saudi Arabia in 1996, and the bombings of the American embassies in Nairobi and Dar es-Salam in 1998, were aimed at the terrorists' former patrons. Saudi Arabia belatedly discovered that indiscriminate religious proselytizing could on occasion backfire, and has since modified its policy.

11.2 Domestic Politics: The Power of Islamic Business and Finance

Are Islamic financial institutions part of an Islamic 'civil society' working to de-legitimize governments? Are Islamists in business and finance bankrolling subversive activities? Are they tied to, or are they used by, radical groups? In every country, the answers to these questions are different. This section considers the political aspects of Islamic finance and the ties between Islamic financial institutions and political movements in Saudi Arabia, Turkey, Iran, Egypt, the Sudan and Indonesia.

11.2.1 Saudi Arabia: Islamic Finance and the Possible Delegitimation of the State

Saudi Arabia is justifiably preoccupied by any challenge to its religious legitimacy. As the birthplace of Islam and as a country whose king requested in 1986 to be identified as the 'Custodian of the Holy Shrines' (Khadim al-Haramayn al-Sharifayn), it has been vulnerable to criticisms expressed over the years about the compatibility of its policies with Islamic ideals.[5] The ruling family was stunned when, in late 1979, the Great Mosque of Mecca was seized, for a few weeks, by Muslim fundamentalists. Underground opposition groups have since grown increasingly visible and vocal, calling for the overthrow of a regime accused of squandering the oil wealth, being too closely aligned with the United States and the West, allowing (since the

Gulf crisis of 1990) the stationing of foreign troops on its territory, and more generally of being un-Islamic.

The ruling family's legitimacy is based on its Islamic credentials but the management of the economy and the banking system are based on Western practices. One can therefore understand why the Saudi Arabian regime is so touchy on the subject of Islamic banking. The government plays up the fact that the inter-governmental Islamic Development Bank is headquartered in Jeddah, yet the two largest Islamic banking groups, Dar Al-Maal Al-Islami and Dallah Al-Baraka, both owned by prominent Saudis, cannot obtain licences to operate commercial banks in the kingdom. And when the Al-Rajhi Banking and Investment Company was authorized in 1985 to engage in interest-free banking, it was on the condition that it did not use the word Islamic in its name.[6]

Saudi Arabia does not recognize the concept of Islamic banking. The logic is that if one bank is recognized as an Islamic institution then all others, by implication, would be un-Islamic. The official line is that all banks operating in Saudi Arabia are by definition Islamic. In addition, the country's vast bank deposits and foreign holdings generate substantial interest income, and thus the Saudi authorities tread carefully around the issue of riba.[7] Saudi banks for example report interest income as 'special commission income', as 'service charges' or as 'book-keeping fees'.[8]

11.2.2 Turkey: the 'Dangerous Relationships' between 'Finance Houses' and Islamic Fundamentalists

Alone among Islamic countries, Turkey has since 1924 adopted a staunchly secular political system. Despite strict rules against the political use of religion, Islamist groups have in recent years become increasingly visible. In 1996, for the first time in its history, Turkey had an Islamist prime minister. Necmettin Erbakan, leader of the Refah (or Welfare) party, ruled for less than a year.[9] Throughout his long political career, Erbakan had advocated such measures as outlawing interest rates and replacing the Turkish lira with a vaguely defined 'Islamic dinar'. Yet as Prime Minister, he proved quite pragmatic. He was nonetheless forced to resign in 1997 under pressure from the military-dominated National Security Council, Turkey's highest decision-making body, which considered itself the guardian of Ataturk's ideal of secularization. The new government has since engaged in a crackdown on all forms of Islamism, particularly in business and finance.

Although certain segments of the business community have at certain times and in certain areas been associated with Islamic militancy,[10] the Islamicization of business is a rather recent phenomenon. Ironically, Islamic finance had officially come to Turkey during the very secular Ozal years in the early 1980s.[11] At a time when the need for cash was pressing and

the Islamist danger appeared remote, Turkey welcomed investments from oil-rich states and their citizens. Islamic institutions, under the name of 'Special Finance Houses', and with capital from Saudi Arabia and Kuwait, were given special privileges.

The election of a Welfare party mayor in Istanbul marked a turning point. Small engineering, service and contracting concerns which stressed their Islamic character won the business of the city. Islamic business networks grew bigger and more assertive.[12] In 1996, with the advent of an Islamist-led government, secularist groups led by the military launched an unrelenting campaign accusing the government and its allies of trying to establish an Islamic state. In the all-out war against Islamist groups, business and financial groups were a central target. By certain estimates, Islamic companies held $2.5 billion in investments in Turkey in textiles, media, chemicals, automobiles, food, tourism and transportation. The Islamist Independent Businessmen's and Industrialists' Association, also known as Musiad, founded in 1990, had 3,000 members by 1997, most of them small or medium businesses based in the Anatolian heartland. Military spokesmen alleged that 100 major businessmen controlling 1,000 companies were financing fundamentalists, undermining the 'regime' and 'planning to buy privatized companies'. Six of the businessmen were said to be worth more than $700 million each. Kombassan, a 35-company provincial cooperative that has grown rapidly on promises of a better-than-25 per cent return on investments, saw its bank accounts frozen. Hasim Bayram, the head of the cooperative, responding to accusations that he was running a pyramid scheme, declared: 'This is not about ideology. It's political. This is about the old system, and old monopolistic capital, keeping the others out.'[13] As for the Finance Houses, they were accused of having 'a dangerous relationship' with the Islamists.[14]

The subsequent crackdown on Islamism included banning the Welfare party, increasing penalties against the opponents of secularism, establishing new bodies in every province to guard against Islamic fundamentalism, and stepping up government control over schools. The army issued a blacklist of 100 prominent capitalists associated with Islamist groups, and all 3,000 members of Musiad. Islamic companies were subjected to harassment and punitive audits. Corporations identified as contributing to Islamic causes were prevented from receiving public contracts or subsidies, and new legislation brought the Special Finance Houses under stricter control and eliminated their special privileges.[15]

11.2.3 Iran: The Historical Ties between the Bazaar and the Ulema

In Iran, the business community has long-standing ties to the clergy. The alliance of the Bazaar (literally, the marketplace, a reference to the traditional merchants) and the ulema goes back to the nineteenth century.

Both groups were allied against the Qajar monarchy which they accused of being a puppet of foreign powers. When in 1890 the Shah granted a British company a monopoly over the sale and export of tobacco, a nationwide boycott and strikes ensued, led in large part by merchants and clerics. The formative events of the development of Iranian nationalism, the Tobacco Protest (1891–2) and the Constitutional Revolution (1905–11) consolidated the alliance of Bazaaris and ulemas. The symbiosis was based on a mutually beneficial alliance: the clergy could afford its political autonomy thanks in large part to the zakat paid directly to them by the merchants; mosques and shrines located close to the Bazaar provided refuge for individuals and groups that feared governmental arrest or harassment.[16]

Such ties persisted over time, and in the years preceding the Islamic revolution, the Bazaaris proved to be among the most effective opponents of the Shah. Economic factors – in addition to religious and other grievances – again figured prominently in this alliance. The land reform, which was a part of the Shah's White Revolution in the early sixties, deprived the clergy of substantial land holdings. And the Bazaaris saw a steady erosion, in relative terms, of their economic power. While they benefited from the oil boom of 1973–4, they felt marginalized in an economy increasingly dominated by foreign investors, the immediate entourage of the Shah and a 'new class' of secular and pro-Western entrepreneurs and professionals.

Soon after the Islamic revolution, the clergy became an economic force in its own right. The new regime nationalized large segments of the economy, including banks. But the religious establishment also controlled a number of 'foundations', the most important of which – the Bonyad-e Mostazafan (Foundation of the Oppressed) – was established with funds confiscated from the Shah's family and entourage. Although ostensibly created to help the poor, it was also a massive business enterprise – in fact Iran's largest holding company – controlling some 1,200 firms worth hundreds of millions of dollars.[17]

11.2.4 Egypt: The Tensions between Secularism and Islamism

The Egyptian case is in one way unique: it is one of few Islamic countries where the top religious establishment has approved of interest-based lending.[18] Yet from the standpoint of government suspicions about Islamic finance, the country is quite typical: the government worries about the potential of the Islamic sector, despite its heterogeneous and decentralized nature,[19] to destabilize the state.

Faisal Islamic Bank of Egypt (FIBE), the largest financial institution, represents the dominant model. From its inception, it strove for inclusiveness and political respectability. Prince Mohammed al-Faisal al-Saud attempted to include among the bank's founders and shareholders the widest possible array of political, economic and religious figures, ranging

from Prime Minister Abd al-Aziz Hijazi (who later became a leading proselytizer of Islamic economics), to the most prominent infitah businessman, Uthman Ahmed Uthman, to leading Islamist figure Tawfiq Mohammed al-Shawi. Most revealing were Prince Mohammed's efforts to include the Waqf ministry among the shareholders.[20]

The greatest political clash occurred with Islamic Money Management Companies (IMMCs).[21] Unlike the Islamic banks, they were unregulated entities working outside of the official channels and thus escaped government control. Most serious analyses of the phenomenon show that with very few exceptions, the IMMCs, just like other Islamic financial institutions, shied away from partisan politics. One notable exception was Al-Sharif, the oldest IMMC, whose owner had ties to the Muslim Brothers.[22] The Muslim Brothers also controlled Al-Taqwa ('Piety'), a bank registered in the Bahamas, but which was denied permission in 1988 to operate as a commercial bank in Egypt.[23] The IMMCs were nonetheless repeatedly accused by the government, particularly during the 1987 elections (which saw a strong showing of the alliance between the Wafd party and the Muslim Brothers), of political meddling. Their meteoric growth caused concern. Not only did they have the resources to influence the electoral outcome, but the dynamic they had created and the symbolism they were using were considered dangerous. The advertising slogan of the Al-Rayyan group, the largest IMMC – 'the blessings behind success' ('al-baraka wara al-najah' – see Chapter 8) – was a subtle reminder of the rallying cry of the Muslim Brothers and other Islamist groups ('Islam is the solution').

Authoritarian governments tend, usually for good reason, to have a nagging suspicion that agitation is occurring underground, and that it has the potential to turn into a groundswell. The operative word is potential. The vast network of private voluntary organizations, given its size and resources has the potential to challenge the state. In Egypt, low-cost clinics and social-welfare centres have been providing essential services to areas that have been all but abandoned by the government. The Islamic 'civil society' was in a position to challenge the government to reform itself and open itself to greater democratization.[24]

The paranoia was fed by selective evidence. Thus the name of Sheikh Omar Abdul-Rahman, the spiritual adviser of Tanzim al-Jihad – the group accused of assassinating Anwar Sadat – and alleged mastermind of the 1993 World Trade Center bombing, has surfaced on a couple of occasions. He had been employed by one of the IMMCs as a middleman in a major business deal.[25] He was also one of the dozens of nominal 'founders' of the Faisal Islamic Bank of Egypt.[26] Such 'evidence' of course proves nothing other than the need for financial institutions to surround themselves with religious figures as a means of asserting their religious legitimacy. Yet as the following pages will show, such isolated facts are on occasion dredged up to 'prove' that Islamic financial institutions have ulterior political motives.

11.2.5 The Sudan: Islamicization of Politics, Politicization of Finance

When the Faisal Islamic Bank was licensed by President Nimeiri in 1978, it was under circumstances very similar to the licensing of the Faisal Islamic Bank of Egypt. In both countries, the bank obtained significant tax and regulatory breaks. But the evolution of the Sudanese bank was driven by the country's political and economic context. It quickly became the second largest bank, and developed close ties with Hassan al-Turabi (who had previously spent a number of years in exile in Saudi Arabia) and his National Islamic Front (NIF), playing a key role in promoting Islamic businesses and Islamic causes. By certain accounts, 'Turabi virtually controlled the bank'.[27]

The Islamicization of the entire banking sector in December 1983 further upset the country's delicate political, economic and religious balance.[28] The Khatmiyya, a sufi sect which, since colonial rule, had enjoyed considerable power among petty traders, was increasingly displaced economically and politically by the Muslim Brothers. According to one analysis,

> The investment pattern [of Islamic banks] encouraged the growth of small and medium sized businesses, and has effectively ensured support for the Muslim Brothers from the middle and lower strata of urban entrepreneurs. This has led to conflict with the traditional export-import merchants, mostly linked to the Khatmiyya order, who had previously dominated this sector and whose members have little access to Islamic bank financing.[29]

Both under Nimeiri and under his successors, tremendous economic privileges were enjoyed by the Muslim Brothers, and businessmen close to them. They benefited from preferential allocations of bank loans, customs exemptions, and foreign currency for imports. They were the main beneficiaries of the privatization programmes, and were given advance notice of currency devaluations.[30] Members of the Khatmiyya, unable to obtain bank loans, resorted to trading foreign currency to maintain their business operations. The government crackdown on 'black market' currency traders (which included the death penalty for offenders) was justified by the need to curb inflation, but it was also interpreted as a way of maintaining the Islamic banks' (and by implication the Muslim Brothers') monopoly on commercial lending.[31]

In a bid to regain their monopoly of the country's retail trade and financial system, the Khatmiyya established the Sudanese Islamic Bank in 1982. But Nimeiri used both his ties to Saudi financiers and the domestic support of the Muslim Brothers to reconfigure the economy. By 1983, the Muslim Brothers were among Nimeiri's few remaining supporters[32] and his decision to Islamicize the financial system was designed to benefit them.[33]

One of the consequences of the Islamicization of finance was a forced Islamicization of economic, political and social life. Indeed, an aspiring

businessman, to qualify for an Islamic bank loan, had to provide references from an already established businessman with a good record of support for the Muslim Brothers. 'This has led to almost comic attempts on the part of many in the urban marketplace to assume the physical as well as religious and political guise of Islamists'.[34] In sum, the Muslim Brothers initially obtained economic privileges for political reasons. This allowed them to become a state within the state, and in due course to overtake the state.

11.2.6 Indonesia: Co-optation and Pre-emption

It had long been assumed that Indonesia would not be hospitable to Islamic finance.[35] Although the country is inhabited by some 190 million Muslims (who account for some 90 per cent of the population), it had a strong secular and multi-ethnic tradition. Full-scale Islamicization did not occur until the fifteenth century. The Indonesian brand of Islam, introduced primarily by merchants and imbued with sufi influences, blended easily with local traditions and customs. Due to their somewhat diluted and syncretic beliefs and to the low level of religious practice, Indonesians have often been referred to as 'nominal Muslims'. In the political and economic system, the *primubis* (the ethnic or 'native' Indonesians, most of them Muslims) historically played a marginal role.[36] Since the days of the Dutch occupation (1678–1942), economic power has belonged to the Chinese. To this day, although the Chinese constitute only about 3 per cent of the population, they own most of the leading conglomerates, and have maintained such close ties with the Suharto family that Indonesia has come to epitomize 'crony capitalism'.[37] Comparable in numbers, the Indonesian Christians have been disproportionately represented in the government and the military.

The delicate ethnic, religious, political and economic balance was maintained through a system of 'religious secularism'. The Indonesian constitution affirms the belief in 'One, Supreme Divinity' as the first of its 'five principles' (*pancasila*) but it does not mention Islam or even Allah.[38] The system whose motto is 'unity through diversity' emphasizes the importance of consensus (*mufakat*), which is also used as a justification for authoritarianism.

For most of the rule of President Suharto (1965—98), neither the Islamic religion nor its leaders played any significant political role. But with the rise of Islamist opposition, Suharto started courting religious leaders and made openings to the more devout segment of the population. He gave his blessing to the creation of the Association of Moslem Intellectuals (ICMI), an influential grooming ground for leaders, founded by B. J. Habibie (who became in 1998 Suharto's successor). The government relaxed restrictions on Islamic dress. The Suharto family made a widely publicized pilgrimage to Mecca. Islamist groups such as Nahdathul Ulama and the Muhammadiyah,

both partisans of a moderate and non-political Islam, and focusing instead on the expression of religious faith through social programmes, education and moral guidance were increasingly co-opted, in part as a way of undercutting extremist groups. A number of Christian figures in the army and in government were replaced by Muslims.[39]

Thus Suharto became a patron of Islamic banking. Soon after the Indonesian Ulemas Council (MUI), the country's highest Muslim authority, resolved in August 1990 that an interest-free banking system should be established, it was the Amal Bhakti Muslim Pancasila Foundation (of which Suharto was chairman) which gave the MUI an interest-free loan of Rp3 billion; this was as a deposit to establish Bank Muamalat Indonesia (BMI) and support its banking licence application. Suharto also offered the presidential palace in Bogor in West Java as a venue for the sale of shares to the public. When the bank opened in 1992, it had shareholder commitments totalling Rp106 billion, an amount exceeding the paid-up capital of any Indonesian bank at the time. BMI was also to become the catalyst in the development of an Islamic financial sector. And indeed, soon afterwards, a number of rural Islamic banks and credit cooperatives were established. In 1994, together with the MUI and the Association of Indonesian Muslim Intellectuals, the bank launched the country's first Islamic insurance company, Syarikat Takaful.

The name Muamalat comes from the Arabic word *amal* ('work'), connoting the performance of good deeds. True to the country's developmental orientation, BMI's mission was to help the government in the process of national economic development, particularly in relation to small- and medium-scale entrepreneurship. Interestingly however, BMI's articles of association do not limit its shareholders to Muslims, and a significant segment of its clientele consists of non-Muslims.[40]

11.3 Islamic Finance and International Politics

A recent book about Islam and the West suggested that the principal purpose of Islamic banks was to fund terrorism.[41] Such perceptions are not uncommon, even among bankers[42] and policy-makers. Indeed, Islamic bankers have found themselves in the crossfire of the 'war against terrorism' that started a few years ago. Before dealing with this issue, a digression into the 'Islamic threat' and the 'New World Order' is necessary.

11.3.1 'The Islamic Threat' and the New World Order

Fears over global Islam started with the Iranian revolution, and were later greatly amplified with the demise of Communism and the search for a new enemy. John Esposito offers a useful summary of the Western mindset in the wake of the revolution:

> Amid the hysteria of the postrevolutionary period, assessing the Iranian threat, separating fact from fiction, proved difficult if not impossible for the West and its allies. The shock of a revolution which had made the unthinkable a reality resulted in an overcompensation that saw both Iranian domestic politics and foreign policy through the lenses of Islamic radicalism and extremism.'[43]

The collapse of Communism made things worse. In January 1991, columnist William Pfaff wrote: 'There are a good many people who think that the war between communism and the West is about to be replaced by a war between the West and Muslims.'[44] Indeed, the 'threat vacuum' made Islam the most likely candidate for 'global enemy'. Shortly after the fall of the Berlin Wall, columnist Charles Krauthammer had warned of an 'unnoticed but just as portentous global intifada … an uprising spanning the Islamic world'.[45] Islam was all the more threatening in that most influential pundits and academics posited a fundamental incompatibility between Islam and Western values. Thus, Amos Perlmutter, a professor at Washington's American University, wrote: 'There is no spirit of reconciliation between Islamic fundamentalism and the modern world – that is, the Christian-secular universe.'[46]

The theme of Islam as new global enemy soon dominated foreign policy thinking.[47] The influential journal *Foreign Affairs,* published by the Council on Foreign Relations, carried a debate: 'Is Islam a Threat?' (Judith Miller answered 'yes', Leon Hadar answered 'no').[48] The debate was given, if not theoretical and historical depth, at least academic cachet when Harvard University's Samuel Huntington wrote his famous *Foreign Affairs* article, 'The Clash of Civilizations?', which argued that future conflicts would break out along civilizational lines, with Islam and Confucianism epitomizing those 'civilizations' that were inherently hostile to Western values. According to the journal's editors, the article generated more discussion than any article since George Kennan's 1947 piece 'The Sources of Soviet Conduct'. Writing under the by-line 'X', Kennan had provided the intellectual foundation for the containment policy, which dominated foreign policy thinking throughout the cold war. For many, 'The Clash of Civilizations?' would do the same for the post-cold-war era.

Huntington later expanded the article into a book, which was more thoughtful and more nuanced, yet in the policy debate the appealing sound bite remained: it is all about 'the West against the rest'.[49] In its simplicity, the thesis was appealing to foreign policy experts who since the end of Communism had been frantically looking for a new foreign policy doctrine. A few fringe Islamist groups who have 'declared a jihad' against the United States or the West suddenly became a threat comparable to that posed by Soviet Communism during the cold war… Playing up the threat was convenient to intelligence agencies and other organizations who needed to justify their funding, indeed their existence. In April 1995, the

director of the Central Intelligence Agency (CIA) testified that Islamic terrorism posed the 'single greatest threat' to American interests.[50] In the same way that countries played the anti-Communist card to obtain US aid, many governments in the Islamic world had an interest in exaggerating the threat posed by 'fundamentalist' groups. The 'threat' made good copy and was taken up, as earlier quotes have shown, by journalists who were quick to relay, and even amplify it, and 'experts', many of whom made a career out of 'explaining' its roots.

The scenario of an 'Islamic Internationale', a 'Khomintern', or a 'Tehran–Khartoum' axis has since become a fixture of the foreign policy debate. Kevin Phillips, publisher of the *American Political Report*, sees a 'minaret curtain' replacing the 'iron curtain'. He argues that the West is on 'five distinct collision courses with Islam':

> The explosive Muslim immigrant ghettos could disrupt half the major cities in Europe; US troops have been put in the line of ancient hatreds in Bosnia; war threats in the biblical lands smack of fire drills for Armageddon; the suppression of oil prices to 25-year lows strikes at Muslim economies from Nigeria to Indonesia; and financial colonialism is a provocation.

Borrowing another theme from Huntington, that of an Islamic–Sinic alliance uniting non-Western civilizations, Phillips builds an ominous scenario:

> China, the other demographic Goliath, has been a frequent ally in areas such as nuclear nonproliferation, and the two cultures make a good fit: Chinese commercial skills with the fervent radicalism of the Muslims. Together, the two groups are predicted to have 30 percent of the world's population in 2010, with just 12 percent for the West. Compare that to 1920, when the West had 48 percent and the Sino-Muslim nations 20 percent.'[51]

Such analyses are founded on a number of dubious yet oft-repeated axioms: Islam is a monolith and all Muslims are united in action; and all Islamists, perhaps even all Muslims, are at heart radical and anti-Western. As has been shown throughout this book, Islam is extremely diverse and fragmented. To be sure, there are a number of pan-Islamic organizations whose rhetoric emphasizes cooperation if not unity. Most are in fact allies of the United States. In addition to groups such as the Organization of the Islamic Conference (OIC) or the Arab League, there are a number of sub-groupings onto which superficial observers find it is easy to project unity of purpose and action. In 1997, an initiative by the Prime Minister of Turkey, Necmettin Erbakan, designed to fight poverty and establish a 'just world order', led to the first meeting of the 'Developing 8' – Turkey, Pakistan, Indonesia, Iran, Bangladesh, Egypt, Malaysia and Nigeria; countries with

little in common, other than their Islamic character. From the outset, representatives disagreed on all major issues, reflecting variations in ideology, global outlook and economic priorities, yet the meeting ended with the requisite pledge of cooperation in several economic fields, including industrial development, research, banking and agriculture.[52] Similarly, a meeting of the newly formed 10-country Organization of Economic Cooperation (OEC) brought together representatives from Turkey, Iran, Pakistan, Azerbaijan, Afghanistan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.[53] Pledges of economic cooperation were overshadowed by deep political differences. Perhaps more striking were the religious differences between the Iranian leaders and the Afghanistan's Talibans. The two countries, both claiming a return to true Islam, were in 1998 on the brink of war and engaged in the familiar process of mutual excommunication.

Even less significant yet more worrisome in the eyes of the proponents of a 'global Islamic threat' are the periodic meetings of radical and anti-Western groups from the Islamic world. One such meeting in Khartoum in April 1995 brought together 300 delegations from 80 countries. Fiery denunciations of the West and calls for a holy war are mostly posturing, empty rhetoric and inconsequential palaver, yet they receive wide coverage and become positive proof of the existence of a grand Islamic conspiracy. In many respects, the Western paranoia about global Islam mirrors the conspiracy mindset within the Islamic world. In his book *The Hidden Hand: Middle East Fears of Conspiracy*, Daniel Pipes argues that conspiracy theories have five basic assumptions in common: 'conspiracies drive history, everyone seeks power, benefit indicates control, coincidences don't happen, and appearances deceive'.[54] Edward Said has observed that '[t]he Islamic threat is made to seem disproportionately fearsome, lending support to the thesis (which is an interesting parallel to anti-Semitic paranoia) that there is a worldwide conspiracy behind every explosion'.[55] Yet a belief that any action is part of a big and sinister plot breeds suspicion, and, as noted by Pipes, 'acting on [such] beliefs then alters the course of events. Ironically, fears of conspiracy also directly lead to the proliferation of actual conspiracies'.[56] Designating, as President Clinton did in 1998, Usama bin Laden as 'America's public enemy number one' no doubt reinforced both bin Laden's stature within radical Islamist groups and his commitment to a 'jihad' against the United States.

Hostility to Islam in the West is also fed by the feeling that the 'enemy' is deeply 'infiltrated', and that political, indeed terrorist, movements hide behind the facade of religion. It is not rare to find newspaper headlines claiming that 'terrorists use US to fund attacks' or that 'America is a home away from home for terrorists', or articles arguing that 'the nation is the enemy as well as an international cash cow [terrorists] can milk for various operations', that 'there are many ways – from charity to crime – in which this country has become a cash cow for terror', or that 'America has long

been the immigrant's golden land and today, terrorists are exploiting that gold to finance their operations around the world'.[57]

Anti-Islamic punditry has become something of a cottage industry. Steven Emerson, who bills himself as 'an expert on militant Islam', gained fame when, soon after the Oklahoma City bombing, he rushed to insist that only Muslims could be the perpetrators of the worst act of terrorism in American history. He said that Oklahoma City was a 'natural' target because of the number of mosques in and around the area and that the bombing was 'done with the intent to inflict as many casualties as possible. That is a Mid-Eastern trait'.[58] (The perpetrator turned out to be Timothy McVeigh, an American with ties to white supremacist militias.) Similarly, in a plea to 'stop aid and comfort for agents of terror', Emerson claimed that Hamas 'operate[d] an extensive network of front groups, from San Diego to Houston to New York City, under religious, charitable and human-rights monikers'. He cited a 1995 statement by Admiral William O. Studeman, then acting CIA director, to Congress: 'Several [terrorist] groups have established footholds within ethnic or resident alien communities here in the U.S. These communities offer terrorists financial support and a source for new recruits'.[59]

Emerson also argued that militant Islamic religious organizations 'deliberately commingle legitimate activities with illegitimate ones' as they 'raise tens of millions of dollars a year – much of it through tax-exempt charitable organizations – which in turn transfer the money to overseas militant Islamic groups or which directly fund militant Islamic activities in the U.S.'[60] The corollary to the idea that Islamic organizations 'commingle' funds dedicated to charity and proselytizing and funds dedicated to terrorism is that any religious or charitable organization can automatically be suspected of pursuing a political agenda. A 1995 presidential order froze $800,000 in funds for a list of terrorist organizations. In a high-profile investigation, the US Customs Service looked into the World and Islam Studies Enterprise foundation (WISE), a Tampa, Florida-based organization linked to a Saudi Arabian-financed think tank called the International Institute of Islamic Thought (IIIT), which allegedly raised funds for 'organized terrorist groups' under the guise of collecting money for orphans and the families of 'martyrs' of the Islamic cause.[61]

Just as any charitable organization can be suspected of serving as a front for a political, indeed a terrorist, agenda, moderate Islamists can be assumed to be radicals hiding their game for tactical reasons. In her book on 'militant Islam', *New York Times* journalist Judith Miller saw in the political evolution of Sudanese leader Hassan al-Turabi a more general pattern:

> Turabi had been tolerant in opposition when a democratic outlook was useful. Out of office, Turabi had spoken the language of reform and pluralism; … ruling, however, was something else. Martin Kramer, the Israeli analyst of militant Islam, argued that as a rule, an Islamic

> militant's 'moderation' was inversely correlated to his proximity to power; the farther away from power Turabi had been, the greater his so-called moderation. Bernard Lewis, another fierce critic of Islamic absolutism, had put it this way: 'Moderation', or 'pragmatism' in a radical fundamentalist movement usually reflected a lack of alternatives. An Islamic 'moderate', he quoted Arab friends as saying, was one who had 'run out of ammunition'.[62]

Other examples could have led to the opposite conclusion: Islamic extremists often turn into moderates. In Malaysia, Anwar Ibrahim, the one-time deputy Prime Minister, had in his youth spent two years in prison for his association with radical Islamist groups. Following his sacking and arrest by Mahathir Mohammed, he became a symbol of modernity and liberalism.[63]

The implication of the preceding arguments is that Islamic countries are bound to have a common foreign policy, which in due course would lead to a jihad against 'the West'.[64] Since 1972, when Pakistan launched its nuclear programme, and especially when during the 1974 Lahore summit it used the argument of Islamic solidarity to obtain financial help from Libya, the 'Islamic bomb' has been at the forefront of doomsday scenarios.[65] The wording is itself revealing – since one seldom hears of a Christian, Jewish or Hindu bomb – but more significantly, theory, history and all the available empirical evidence suggest that, despite the rhetoric, there is no such thing as an Islamic foreign policy, which would presumably be led by countries such as Iran. Examples abound of the inability of Islamic countries to unite in the face of major crises. Relations between and among 'fundamentalist' states – Saudi Arabia, Pakistan, Iran, Sudan, Afghanistan – are anything but harmonious. At the time of the Gulf War, most Islamic countries sided with the US-led coalition against Iraq, while Iran abstained. Perhaps most dramatically, as we saw, the relations between Iran and the Afghani Talibans are marked by open hostility. History is replete with examples of Muslim rulers uniting with 'infidels' to fight co-religionists. The great Abbasid caliph Harun al-Rashid, whose reign is remembered as a golden age of Islamic achievement, carried on a friendly correspondence with his Christian contemporary Charlemagne, at a time when the latter was engaged in hostilities against the Umeyyad rulers of Spain. Later, in medieval Spain, alliances of Muslim princes with Christians, such as El Cid, against other Muslims, became quite commonplace.[66] Edward Mortimer, in challenging 'the notion of the house of Islam as a single community of believers, whose members owed solidarity to one another in any conflict with outsiders', noted that even in the nineteenth century, 'expressions of solidarity were generally a matter of lip-service rather than statements of serious intent to take risks or make sacrifices where one's own interests were not directly threatened'.[67]

Indeed, most students of international relations argue that national interest considerations trump ideological or religious affinities among states.[68] Similarly, students of comparative politics have observed that the

foreign policies of revolutionary states go through two phases. During an initial stage, revolutionaries are likely to be outcasts intent on exporting their revolution and reshaping the international system. But at some later stage, they end up being accepted in the international community, if not defenders of the status quo.[69] In that respect, Iran is confirming the patterns established by the Soviet and the Chinese revolutions: following a phase of 'lawlessness', it has been moving towards moderation and a more 'responsible' role in the international community.

11.3.2 Saudi Finance and Sudanese Politics

In the Sudan, Islamic finance played an important role in bringing about political Islamicization. Lest one be tempted to draw sweeping generalizations based on that case, one should keep in mind the specific context of Sudanese Islam, more specifically the facts (1) that the Nimeiri regime had moved from Nasser-style Arab socialism to establishing an Islamic state, (2) that for many years (roughly until 1993) the Islamic regime had been dominated by free-market, pro-American policies, and (3) that the leading Islamic figures, especially Hassan al-Turabi, were moderates and friendly to the West. Turabi was warmly supported by the Reagan Administration for his staunch anti-Communism. He visited the United States in 1992, and it was only in 1993 that the Sudan was added to the list of countries supporting terrorism.[70] Even after that date, the Sudan was on occasion helpful in the fight against global terrorism: it delivered terrorist Illich Ramirez Sanchez ('Carlos') to France, and expelled Usama bin Laden from its territory.

Many writers have conflated and compressed a complex series of events to show that Islamic banks were instrumental in bringing about a 'rogue state'. The role of the Faisal Bank of the Sudan bolstered the argument that money collected in the name of Islam is in the final analysis used for political ends, and that even conservative, pro-Western regimes promote radical Islam. Thus Judith Miller concludes that 'Saudi and Gulf support, though diffuse and often ostensibly donated to cultural and charitable Islamic causes, has been equally, if not more, consequential for Islamist groups [than Iranian funding].'[71]

In reality, arguing that the Saudi regime wanted to create the kind of regime that exists today in the Sudan would be tantamount to arguing that the United States conspired to create the rabidly anti-US 'Afghan Arabs'. The point is that unintended consequences should be distinguished from conscious agenda. Saudi Arabia has attempted to deal with the unwitting fall-out from its indiscriminate generosity by enacting in 1993 and 1994 a number of changes in its proselytizing efforts. It set up a Supreme Council of Islamic Affairs, headed by Prince Sultan, to consider aid requests from Islamic groups, and banned the collection of private money within the kingdom for charitable Muslim causes without Interior Ministry permit.

11.4 Guilt by Association

11.4.1 Rogue States, Rogue Banks and Rogue Financiers

Although couched in neutral terms and stressing the need to depoliticize banking, the new norms of global banking are eminently political insofar as they are inextricably linked to the New World Order that came into being with the end of the cold war. 'Rogue' states are outcasts within that system, and acts of defiance can bring forth economic and financial sanctions.[72] Following the 1988 terrorist bombing of Pan Am Flight 103 over Lockerbie, Scotland, the United Nations Security Council imposed sanctions on Libya (resolutions 748 and 883). And in May 1998, following nuclear testing by India and Pakistan, both countries were immediately subjected to financial sanctions, and deprived, among other things, of IMF loans. Other countries such as Iran, Libya, Iraq or the Sudan, often appear on the US State Department's list of countries supporting terrorism and have also been subject to similar sanctions.

A related trend is extraterritoriality and secondary boycotts. In 1996, the Iran and Libya Sanctions Act was approved without dissent by both the US House and Senate and signed into law by President Bill Clinton. The legislation passed requires the president to impose sanctions against any foreign person or company that invests $40 million or more in a year in Iran's or Libya's petroleum or natural gas sectors. Among the possible sanctions are the following: denying Export-Import Bank loans, denying export licences, barring US banks from making loans of more than $10 million a year to sanctioned parties, barring sanctioned financial institutions from being primary dealers of US government bonds, etc.

Insofar as these 'rogue' countries are part of regional banking networks, banks from Islamic countries have on occasion felt pressure to modify their ownership or management structures. In 1995, Abdullah Saudi, the long-serving and highly regarded president of the Arab Banking Corporation (ABC) – whose main shareholders include the Kuwaiti finance ministry, the Abu Dhabi Investment Authority and the Central Bank of Libya – was forced to resign under US pressure because of his Libyan citizenship.[73]

In addition to 'rogue' states, there are 'rogue' banks and 'rogue' financiers within the system. Until its closure in 1991, the Bank of Credit and Commerce International (BCCI) – nicknamed in intelligence circles the Bank of Crooks and Criminals International – epitomized the rogue bank. A number of guerrilla groups and terrorist organizations took advantage of its large, loosely regulated and transnational network.[74] It was also one of the banks through which Pakistan was able to acquire nuclear weapons.[75] Then there are 'rogue financiers', whose emblematic figure is now Usama bin Laden. In the wake of the African embassy bombings of August 1998, bin Laden was no longer perceived as simply a freelancer who had

'internationalized and privatized' terrorism, but as the centre of a vast network keen, among other things, on acquiring the nuclear bomb. A newspaper headline said it all: 'A Global, Pan-Islamic Network; Terrorism Entrepreneur Unifies Groups Financially, Politically'.[76] In the wake of the bombings, the names of two Islamic banks kept surfacing, thus lending credibility to a conspiratorial view of Islamic finance. One was Al-Shamal Islamic Bank in Khartoum, a joint effort by NIF and Usama bin Laden, who had allegedly invested $50 million in the venture.[77] The other was the Islamic Bank, in Tirana, Albania, an investment bank that had opened in 1994 with financing by Kuwaiti and Saudi interests, and which had been used for money-transfer purposes by a terrorist organization.[78]

11.4.2 The Impact on Islamic Finance

Do Islamic banks have a domestic or international political agenda? Do they play a part in promoting radical Islam and international terrorism? The short answer is that they usually do not, but their opponents point to their resources to show that they have the potential to cause mischief. The suspicions surrounding Islamic banks are implicitly justified by a syllogism: political Islam at the domestic and international level requires financial resources, Islamic banks are committed to Islam and have vast financial resources; therefore Islamic banks are likely to advance the political goals of potentially subversive Islamist groups.

At the international level, Islamic financial institutions are all the more likely to be scrutinized now that the 'war on terrorism', just like the 'war on drugs', is fought in large part on the financial terrain – figuring out the financial flows involved and tracking them nationally and internationally.[79] Consider for example the following quote by Steven Emerson:

> Terrorists have become very sophisticated in laundering and disguising their funds. They use a variety of financial vehicles – front companies, charitable organizations, third-party bank accounts – to disguise the location of their assets. Osama bin Laden's most impressive achievement has been his ability to shield from scrutiny and seizure his $300 million financial empire, held in a financial labyrinth of world-wide shell companies, co-investors, governmental entities, bank accounts, religious 'charities' and plain old blue-chip investments. A portion of Mr. bin Laden's 'portfolio' is held in U.S. and British banks under third party names and transferred to Islamic religious charities operating under false cover.[80]

The rationale for the financial focus of most recent anti-terrorist legislation is twofold. First, tracing financial flows can untangle money puzzles and yield a great deal of information about subversive and otherwise shadowy groups. Second, the use of economic and financial tools –

embargoes, asset seizures and the like – can starve terrorism. Although there is not much evidence that Islamic banks harbour more terrorism-related funds than conventional ones, Islamic banks are, for all the reasons discussed in this chapter, far more likely to be systematically suspected of having been a conduit for such activities.

Notes

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32. Nimeiri's 'September laws' imposing the Shariah to the country had been opposed by the sufi sect, on the grounds that it was politically divisive in a country where 40 per cent of the population was not Muslim.
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12

RELIGIOUS ISSUES AND CHALLENGES: DEFINING ISLAM AND INTERPRETING THE SHARIAH

The battle to define the parameters of Islamic finance – and more generally the struggle over the authoritative use of the symbolic language of Islam – is not exclusively or even principally about religion. Indeed, one of the themes developed in this book is that religion cannot be separated from other factors – economic, political, cultural, ideological, historical, etc. Yet since political and economic struggles are fought on the religious terrain and expressed in religious terms, we need to be able to isolate, insofar as it is possible at all, religious issues. This chapter provides a framework for understanding the religious challenges faced by Islamic banks. It seeks to answer three questions: what are the mechanisms by which financial institutions interpret religion? What are the bases (scriptures, traditions) of the various possible interpretations? What interpretations are likely to prevail? The chapter begins with a discussion of Shariah boards and other mechanisms designed to interpret religion for banking purposes. It then broadens the discussion to contending views on religious interpretation, before adopting a comparative perspective designed to map the likely direction of change in religious interpretations.

12.1 Interpreting the Shariah

Since the aggiornamento of Islamic finance, one of the defining characteristics of an Islamic bank has been the existence of a 'Legitimate Control Body', or 'Shariah Board', whose purpose it is to ensure that the bank operates in conformity with the Shariah. Such a religious supervisory board enhances the credibility of the bank in the eyes of its customers, and bolsters its Islamic credentials. A Shariah board is a prerequisite for admission into the International Association of Islamic Banks (IAIB). The general characteristics of the Shariah board were described as follows in an IAIB document:

> It is formed of a number of members chosen from among Jurists and men of Islamic Jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating their opinion the following are taken into

> account: (a) They must not be working as personnel in the bank. That means: They are not subject to the authority of the board of directors. (b) They are appointed by the general assembly as it is the case of the auditors of accounts. (c) The general assembly fixes their remunerations. (d) The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts.[1]

The exact characteristics and roles of Shariah boards differ from one institution to another, and a number of controversies have occasionally plagued them. A recent survey of 30 Shariah boards has revealed their diversity.[2] In our sample, numbers of members varied from one to nine. (Odd numbers are preferred as a means of breaking possible deadlocks.) All members were trained in Islamic law or religious studies, and about half of them also held degrees in business and economics. Most boards met quarterly; a few met monthly and some annually. Their recruitment, pay conditions, and conditions of employment were usually decided at shareholders' meetings, although in a few cases, such decisions were made by the bank's management.

In theory, the Shariah board's opinions are authoritative in that their refusal to endorse a product should automatically result in the bank scrapping that product. Also in theory, Shariah boards perform a religious audit of all accounts. The reality however is more complicated. Interviews revealed that in many cases the review is perfunctory, with boards 'rubber stamping' decisions already made by the bank's management or shunning controversial issues. The model for the role of the Shariah board is that of the account auditors. Although remunerated by the bank, their members should retain their independence. Like the auditors, they 'certify' at the end of the year that the bank's operations were in conformity with religious teachings. They review the institution's products and policies and issue fatwas as needed and as requested by the institution or its customers. For example, they decide whether a new financial instrument is religiously acceptable, or whether a fee charged by the bank could be assimilated to riba.

A number of issues have been raised in connection with Shariah boards. One is about their independence. Insofar as they derive what is frequently their principal income from their membership in a Shariah board, some scholars may legitimate the most dubious operations. The debate on 'fatwas for sale' raged in Egypt, especially at the time of the Islamic Money Management Companies (IMMCs).[3] The debate was ideological, political, and of course financial, as much as it was religious. It pitted 'private clerics' in the employ of IMMCs and Islamic banks against 'public clerics', functionaries of the state who were critical of these companies. In those 'fatwa wars', each side had its backers. Some argued that in a country where, from the days of Muhammed Ali (1805–49) to those of Gamal Abdel Nasser (1952–70), clerics were an appendage of the state, allowing private

sector income would enhance their independence.[4] Others argued that clerics were in effect becoming mercenaries, ready to offer tailor-made fatwas that would legitimate certain practices on the most tenuous religious grounds in exchange for money. In 1989, the Egyptian press mentioned that some clerics were receiving a monthly stipend as high as $4,000. The implication was that bank clients were cheated in two ways: it was their money that was being siphoned off to make excessive payments; and the religious validity of fatwas that were essentially 'bought' was in doubt.[5]

A related issue is the varying degrees of leniency of Shariah boards. As a general rule, Shariah boards in Southeast Asia tend to be more lenient than those of the Arab Middle East. Indeed, many fatwas issued in Malaysia or Pakistan are not recognized in the United Arab Emirates or Kuwait. One obvious factor is the different religious and historical traditions and practices. Another variable though may be the intensity of competition. The Kuwait Finance House is known for its strict rulings. Under the presidency of Mufti Abdel-Latif Batayban, it has rejected all forms of hiyal (ruses) and various types of murabaha, and has consistently prodded the bank's management into increasing profit-and-loss sharing arrangements.[6] Insofar as the Kuwait Finance House was for most of its existence the sole Islamic bank in the country, thus enjoying a monopoly of sorts on a lucrative segment of the market, it could afford stricter religious rules.[7] So it may be that, at a time of heightened competitive pressures, banks try to compete on the basis of the leniency of their Shariah boards.

Another criticism is that Shariah advisers are not truly necessary, and may be a drag, financially and competitively, on the operations of the financial institution. Insofar as most bank employees are versed in Islamic law and practices, and insofar as the largest banks have in-house research departments that study matters of religion and economics, Shariah boards are perceived by some as being all the more superfluous in that, in the era of e-cash, Internet banking and exotic derivatives, religious scholars may not be up-to-date on state-of-the-art strategic or technological matters. The typical retort of religious advisers is that the religious experience of bank staffers is insufficient and that religious rectitude should prevail over considerations of profitability and competitiveness. They invoke a merchant-faqih tradition in Islam and a quote by Abu Hanifa (founder of the Hanafi school), stating that 'every merchant must be accompanied by a faqih whose advice will allow him to avoid riba'.[8]

From the standpoint of Islamic banks as a collective group, the major criticism is that the practice of banks having their own Shariah boards adds to the fragmentation of Islamic finance, making it difficult to arrive at a consensus on products and procedures, which in turn complicates the task of developing a secondary market for Islamic products. Different boards have different interpretations of the Shariah, and no uniform rules apply to the industry as a whole. Hence the attempts, at the national and trans-

national levels, to develop common standards. To avoid fragmentation and the reliance on the opinions of lone scholars, since the first aggiornamento 'group Ijtihad' has been encouraged, through international conferences, symposia and convocations as well as through permanent new bodies such as fiqh academies. A number of research institutes have been involved in research projects on Islamic finance – among them the International Center for Research in Islamic Economics at King Abdul Aziz University in Jeddah, the Islamic Foundation in Leicester (UK), the Islamic Research and Training Institute of the Islamic Development Bank in Jeddah, and the International Institute of Islamic Thought in Cairo and the Harvard Islamic Finance Information Program in Cambridge, Massachusetts. Increasingly, the old principle of 'ijmaa' (unanimous agreement)[9] was modified to signify broad consensus or even simple majority.

The most prestigious transnational body is the Islamic Fiqh Academy created by the Organization of the Islamic Conference (OIC) in Jeddah. Its members are appointed by governments belonging to the OIC. It holds annual meetings in various locations where reports of specialized experts on a specific issue are discussed. Following debates, a decision by a majority vote states the Academy's position on the issue. The fatwas, debates and reports are published in the *Fiqh Academy Journal*.[10] Despite its multinational membership, the Islamic Fiqh Academy remains closely identified with Saudi Arabia. Other fiqh academies are associated with other countries and other fiqh traditions.

The International Association of Islamic Banks (IAIB) has attempted to promote uniformity in the implementation of Islamic finance by appointing a Higher Religious Supervisory Board of Islamic jurisprudents, whose interpretations would be normative for all member banks.[11] This worked, to some degree, in the early years of Islamic finance. Since the 1980s however, the IAIB's role has steadily diminished. For one thing, a growing number of financial institutions have stayed out of the association, and are thus not bound by its decisions. In addition, the IAIB was weakened by dissension within the Islamic banking community. One instance was the highly publicized conflict between Ahmed al-Najjar, the long-time director of IAIB, and Prince Mohammed al-Faisal al-Saud. Another was the growing rivalry between the Dar Al-Maal Al-Islami of Prince Mohammed and the Dallah Al-Baraka group of Sheikh Saleh Kamel. The Al-Baraka group, rather than following the rulings of the Higher Religious Supervisory Board of the IAIB (which was closely identified with Prince Mohammed and his banks), has tended to adopt its own, more liberal, interpretations of the Shariah.[12]

As for national level coordination, many Islamic countries have appointed Shariah advisers to their central banks. One of the most significant attempts at national harmonization occurred in Malaysia where a National Syariah (Shariah) Board was established in 1997 to harmonize financial

practices and review the compatibility of new financial products with religion, as well as advise the Central Bank on religious matters. The goal was to adopt a liberal, modernist bent that would be consistent with the developmental goals of the government.[13]

One of the risks faced by the Islamic banks and investors may be called the 'religious risk', or the risk of being challenged on religious grounds. On occasion, bankers have been forced, under religious pressure, to change course. Instances where Shariah board decisions led to strategic changes are rare, but they do exist. In 1987, the Faisal Islamic Bank of Egypt had to put an end to its forward contracts in foreign exchange markets.[14] The same year, the Islamic Development Bank changed its practice of charging a fixed service fee of 2.5 to 3 per cent after an Islamic Fiqh Academy fatwa stated that fees should not be fixed arbitrarily, but based on the bank's real costs.[15] In addition, Shariah boards have been pressuring banks to phase out certain mark-up contracts – in particular 'synthetic murabahas' – and to increase profit-and-loss sharing activities.

12.2 Religious Diversity

Religious diversity is a mixed blessing for Islamic banks. On the one hand, it provides flexibility and suggests that new Islamic institutions and products will gain faster acceptance. On the other hand, it casts doubt on the religious validity of certain decisions, and makes a consensus among all religious institutions even more elusive. This section explores the sources of those differences.

Both the exponents of modern interpretations of Islam and those of traditional interpretations can draw on selected scriptures and precedents to bolster their views. Most debates on what the religion truly commands boil down to a few basic questions: 'What is Islam?', 'Who is a true Muslim?', 'How does God Speak?', and 'Who speaks for God?'[16]

Different communities of Muslims have different answers. The literal definition of Islam is 'submission' (to God). The prescribed duties of Muslims are limited to the 'five pillars' of the religion (shahada, prayer, fasting, zakat, pilgrimage). There is no Vatican-like Church that imposes rules and proclaims dogmas. The process of conversion requires no certification of religious knowledge. Thus, beyond a few basics, it is difficult authoritatively to assess religious rectitude. All this leaves significant room to accommodate many interpretations, each claiming authenticity. Furthermore, the Islamic tradition posits the absolute equality of all Muslims, with the degree of piety (which can only be assessed by God) being the only differentiating factor.

Every major belief system has contradictory strands. Ideologues and theologians find coherence through exegesis, but they still disagree amongst themselves on issues of 'essence' and original meaning. In Islam,

one can choose to focus on the Prophet's original role as political ruler and military conqueror, and on the role of holy wars in Arab conquests and in the propagation of Islam. Or one can choose to concentrate on the peaceful, tolerant side of the religion, on the Koranic verses saying that there is no compulsion in religion (2:256),[17] that diversity in religious beliefs is part of God's overall plan (10:99),[18] or that relations with non-Muslims should be marked by kindness and equity (60:8).[19]

A wide spectrum of intellectual, moral and theological traditions is still in existence today. Different strands of Islam can claim lineage from leading Islamic figures. In addition to the concept of 'shura' (consultation) which is mentioned in both the Koran and the Sunna, early Islamic thinkers devised a number of concepts designed to control political power. Al-Mawardi (d. 1058) advanced the concept of separation of functions via delegation from the ruler (tawfid).[20] The philosopher Abu al-Walid Ibn Rushd, known to the West as Averroes (1126–98), developed the theory of tawil or allegorical interpretation, placing reason above all other considerations. He argued that religious texts have an exoteric and an esoteric meaning. If the exoteric meaning is at variance with reason, the text must be interpreted according to reason. Following Aristotle, Averroes gave priority to demonstrative proof (burhan), the highest form of certainty, over the dialectical and rhetorical arguments of theologians. In his lifetime, he lost his intellectual battle. He was tried for kufr (unbelief), his books were burned, and he was banished to his village. Centuries later, the publication in Cairo in 1925 of Ali Abd al-Raziq's *al-Islam was-usul al-hukm* the best-known advocacy of strict separation of the religious and the secular realm, was followed by violent attacks on the book. The author was defrocked by Al-Azhar. This stifled the debate for years to come. Such fates were no different from those of Galileo and countless other Church dissidents. Amazingly (considering common stereotypes about Islam being about 'din wa dawla' [fusion of mosque and state] while Christianity is supposedly inherently secular[21]) Averroes' ideas were used in the West to propound the separation of church and state. More specifically, Frederick II (1194–1250), Emperor of Germany and King of Sicily, ordered the translation of Averroes' works so that he could use his arguments in his war against the religious authorities.

Averroes' views were in line with the Islamic tradition of awareness (waii) which implies that Muslims should be exerting a permanent effort of education and reasoning 'so that their knowledge can be applied for the benefit of society, including the economic order'.[22] The flourishing cultural and intellectual life of Baghdad and Spain had kept science and rationalism alive during Europe's Dark Ages, and medieval Islam was a vital link between the ancient world of Greece and Rome and the Renaissance.

The other, traditional, puritanical, and literalist strand is epitomized by Ibn Taymiyya (1268–1328), who spent his life trying to strip Islam of alien

accretions and influences. In recent decades, a number of Islamic revivalists embarked on similar crusades.[23] Both Abul Ala Mawdudi (1903–79), who created the Jamaat-i Islami in India in 1941, and Egyptian Muslim Brother Sayed Qutb (1906–66) associated modern society with the Jahiliyya, the pre-Islamic society, with its connotations of ignorance and paganism.[24] Qutb's views were radicalized following his imprisonment and torture by the Egyptian government (he was later executed). In his influential book *Maalim fi al-Tariq*, he set up a stark dichotomy: a political system could be either Islamic (nizam Islami) or pagan (nizam Jahili). A syllogism of sorts followed: since it is the duty of devout Muslims to establish an Islamic government, it is also their duty to wage a holy war (jihad) against all other governments.[25] The notion of takfir (which could be translated as excommunication) is central to his and his radical followers' thinking. The group Jamaat al-Jihad (Holy War), which assassinated Anwar Sadat on October 6, 1981, maintained that jihad was the sixth pillar of Islam, and that it was the religious duty of Muslims to wage holy war against Egypt's un-Islamic state and its leader.[26]

Often the same Koranic verse, or even the same word, is open to contradictory interpretations. As regards differing interpretations of certain words, the best example is jihad (usually followed by 'in the path of God').[27] Some adopt a militaristic interpretation – that of a holy war against enemies. Others adopt a spiritual interpretation – that of the jihad of the soul. Another ambiguous term is towhid. For some it is a strictly theological concept about the 'oneness' of God (often used in contrast to the Christian doctrine of the Trinity). For others, it is an all-encompassing concept meaning that religion, politics, economics and society should all be one.[28] For others still, it refers to the unification of mankind.[29]

By the same token, the notion of hukumiyya (sovereignty or power) has elicited contradictory interpretations. The fundamentalist slogan 'la hukma illa li-Llah (sovereignty belongs to God alone) was first used by the Kharijites, a marginal and secessionist sect, when they opposed Ali's decision to seek arbitration in the conflict with Muawiyah, the founder of the Umeyyad dynasty. Nowadays, it can be used either to justify a theocracy, or on the contrary to separate temporal and spiritual matters. In Iran, the roles of the velayat-e Faqih, of the Council of Guardians, and of the Assembly of Experts reflect the view that clerics should hold high political offices to keep control over the political system. The view was opposed, at the time of the Iranian revolution by many leading clerics.[30] Indeed, the Iranian Shia tradition had both a strong anti-political element (since unlike the mainstream Sunnis, they rejected the political system that followed the death of Ali, the fourth Caliph) and a Messianic one. Many clerics argued that in the absence of the hidden Imam, no religious leaders were entitled to claim his mantle. (In that respect, their views resembled those of a minority of ultra-Orthodox Jews who opposed Zionism on the

grounds that the return to Israel would be legitimate only if led by the Messiah.) It took the Ayatollah Khomeini's remarkable rhetorical and political skills to impose his interpretation, whereby the supreme jurist would assume power pending the return of the Imam.[31]

Throughout the Islamic world, there are also well-established traditions that regard the state not as a direct expression of Islam but as a secular institution whose duty is to uphold Islam.[32] Other strands, deriving mostly from sufi perspectives, and paralleling similar Christian strands, are decidedly apolitical, if not anti-political. They claim that authenticity lies within the soul of the individual and that it manifests itself in righteous behaviour within the Islamic community. Insofar as temporal power is perceived as inherently violent and corrupt, it should be shunned. Islam would then be circumscribed to a personal and social ethos.[33] A related argument is that Islamic rule cannot be imposed on a society that is not yet Islamicized or permeated by Islamic values, or that an Islamic government can only exist when virtue prevails.[34]

The question of 'who speaks for Islam?' (or whose interpretation is authoritative) is not easily answered either. Edward Mortimer wrote:

> Is it the ruler, who holds power by God's grace? But rulers also fall from power and are replaced by others with different opinions. Does Islam change with every coup d'état? Surely not. Then is it the ulema – those who have devoted their lives to studying Islam and its law? Many believe so, particularly among … the ulema themselves. But are the ulema infallible, even when they all say the same thing? The example of the ban on coffee suggests that they are not;[35] and anyway infallibility is an attribute of God. To attribute it to a group of human beings, even the wisest, may involve the cardinal sin of shirk – associating others with God.[36]

One should add that most contemporary fundamentalist movements, starting with Al-Afghani, have been characterized by revolts against established ulema, who were accused either of distorting the faith or of being too closely associated with the existing political–economic order.[37] Paradoxically, many revivalists have invoked independent reasoning as a weapon against the status quo. They posited that it was up to the individuals themselves to conduct their own ijtihad and make up their mind using their own conscience and intelligence under God's guidance. (Once in a position of power, though, such revivalists have usually suspended that right of individual interpretation.)

On a number of occasions, this somewhat 'Lutheran' approach to the interpretation of the scriptures was used by leaders such as Libya's Moammar Qaddafi. He rejected the ulema's interpretation of Islam by stating: 'As the Muslims have strayed from Islam, a review is demanded. The [Libyan revolution] is a revolution rectifying Islam, presenting Islam

correctly, purifying Islam of the reactionary practices which dressed it in retrograde clothing not its own'.[38] He also instructed the 'popular committees' of the Libyan 'Jamahiriyya' to seize the mosques and rid them of 'paganistic tendencies' and of religious leaders who have been 'propagating heretical tales elaborated over centuries of decadence and which distort the Islamic religion'.[39] But Qaddafi then imposed his own idiosyncratic interpretations of the Koran, with the most controversial decision being changing the Islamic calendar so that it would start in AD 632, the year of the death of the Prophet. He even called for the Sunna to be disregarded on the grounds that it had been corrupted and misinterpreted.[40]

Similarly, Sudan's Hassan al-Turabi in his opposition days had stated that it was up to ordinary Muslims to conduct their own independent reasoning.[41] He also expressed the difficulty of finding an appropriate and applicable political model: 'Muslims themselves sometimes don't even know how to go about their Islam. They have no recent precedent of an Islamic government'.[42] Not surprisingly, once in power, he tried to impose his own Islamic vision, and even to export it. Indeed, every government that calls itself Islamic tends to view its own interpretation of Islam as being the correct one. This has resulted in a greater diversity of beliefs worldwide, but also in authoritarianism at home. Indeed, linking religion and politics is not without certain political advantages for an authoritarian regime. In Iran, the criterion of Islamic rectitude has been more likely 'to verify political reliability and loyalty rather than faith and piety'.[43] As was noted in connection with the Zia regime in Pakistan, when the regime is linked to religion, 'any deviation becomes both a religious heresy and treason against the state … political rebellion and religious dissent become indistinguishable'.[44]

To use Max Weber's categories, religion has been reinterpreted by saints, scholars and warriors. And to use Ibrahim Karawan's typology, monarchs, mullahs and marshals have claimed religious rectitude, attempting to discredit if not 'excommunicate' rival regimes. One of the most enduring rivalries has been that of Iran and Saudi Arabia. In a famous statement, the Ayatollah Khomeini attacked Saudi Islam as 'the Islam of money and power … deception, compromise, and captivity, the Islam of the sovereignty of capital and capitalists over the oppressed … in a word the American Islam.'[45]

12.3 Finance and Religion in Comparative Perspective

In order to predict the likely evolution of Islamic finance, it is useful to consider the ways older but related religions have evolved over time. Will Islam – the youngest of the Abrahamic religions – evolve in the same way as did Judaism and Christianity in political and economic matters and more specifically, with regard to money and finance? Needless to say, all comparisons can be treacherous. Not only can areas of convergence and

divergence be equally significant (thus confusing as much as enlightening), but superficial resemblance often hides fundamental differences. Consider for example the notion of clergy as intermediary between God and the faithful. All clerics preach and interpret the word of God. But there are wide variations in the exact role, importance and status of clerics. The primary function of Catholic priests is to administer sacraments, whereas Protestant ministers are predominantly preachers, Jewish rabbis are more akin to moral teachers and Islamic ulema are essentially legal scholars. Another complication arises from variations within a specific faith and over time. Even broad generic categories (for example, dividing the Jewish faith as Orthodox, Conservative and Reform) can hide significant differences within each category. Yet the opposite position – because no comparison is ever perfect means that all comparative endeavours are futile – limits our understanding.

Perhaps the most enduring cliché in discussions about Islam is the alleged difference between the essence of Christianity, which is said to accommodate, even encourage secularism and separation of church and state, and Islam, which cannot. Hence the formulation of Huntington: 'In Islam, God is Caesar'.[46] The general argument has been summarized by Bernard Lewis as follows: 'The notion of church and state as distinct institutions, each with its own laws, hierarchy, and jurisdiction, is characteristically Christian, with its origins in Christian scripture and history. It is alien to Islam'.[47] For some reason, the early Islamic experience is supposed to be 'indelibly stamped'[48] on the mind of every Muslim. It is true that Christianity and Islam started under sharply differing circumstances. Early Christians placed themselves outside of the existing political order, preaching a message antithetical to existing Judaic and Roman practices. Unlike Jesus, Mohammed was a military and political leader. Under his rule and that of his four immediate successors, political, military and religious leadership were not differentiated. But even in the early days of both religions, the religious position on matters of politics was sometimes comparable. Consider for example Paul's injunction:

> Every person must submit to the supreme authorities. There is no authority but by act of God, and the existing authorities are instituted by him; consequently anyone who rebels against authority is resisting a divine institution, and those who so resist have themselves to thank for the punishment they will receive.

Or his statement that '[The authorities] are God's agents working for your good.'[49] They are not fundamentally different from the Koranic injunction to 'obey Allah and obey the Messenger and those in authority from among you' (4:59). The three religions have tended to evolve over time. In the words of John Esposito: 'The Judaeo-Christian tradition, while once supportive of political absolutism, was reinterpreted to accommodate the

democratic ideal. Islam also lends itself to multiple interpretations; it has been used to support democracy and dictatorship, republicanism and monarchy'.[50]

It is true however that modern concepts of secularism appeared in the Christian West. The seeds of such thinking were introduced with the sixteenth century Reformation. A more systematic political and theoretical formulation occurred during the Enlightenment and, starting in the late eighteenth century, such views started to be implemented in much of the Western world. Since that time, the principle of separation of church and state has by and large become the norm. The word 'secularism' is seldom used in the Islamic context. Also, a certain amount of intellectual intimidation (the equation by radical fundamentalists of secularism with unbelief) has somewhat chilled the debate. For one thing, the concept – as are the categorization of religious traditions and the 'naming of other religious systems or isms' – is a creature of the post-Enlightenment West.[51] The argument that Islam cannot accommodate secularism is more about language than about history and praxis. As we saw, the practice of early Islamic societies often provided for a separation of mosque and state. But despite linguistic and rhetorical differences, secularism does have its Islamic 'functional equivalents'. Some leading intellectuals such as Egypt's Mohammed Said al-Ashmawi have argued that 'Islamism was against Islam'.[52] Others have argued in favour of a sort of 'religious secularism' that would keep institutionalized religion outside the political structure, while developing policy in the context of Islamic values.[53] In Indonesia, the constitution provides for a broad religious framework, but separates the state from any specific faith. Turkey is the most famous case of explicit, assertive secularism. Even there though, secularism was justified in religious terms. In 1924, the same year he abolished the caliphate, Mustafa Kemal in a speech to the Turkish Assembly expressed the need to 'cleanse and elevate the Islamic faith, by rescuing it from the position of a political instrument, to which it has been accustomed for centuries'.[54]

The essentialist analysis conveniently omits what happened between the fourth century and the advent of modern secular states. Indeed, with the Christianization of the Roman Empire, church–state relations were fused. Since AD 379, the obligatory judicial coincidence of Christian and Roman citizenship was established.[55] Whether one looks at the last Roman emperors, at the Byzantine emperors, at the symbiotic relations between pope and emperor in the Holy Roman Empire, or at the 'divine rights of kings' in Western states, one sees that separation of church and state was not the norm, and that theocratic (the subordination of political authority to religious ones) and Caesaro-papist (the subordination of religious authorities to political ones) tendencies alternated for most of the history of Christianity. The paradigmatic jihads (holy wars) were the Crusades, which were perceived by Muslims at the time in much the same way as many

manifestations of 'radical Islamic fundamentalism' are perceived nowadays in the West.[56]

The advent of secularism was neither swift nor peaceful. It took centuries of religious wars and intellectual debates before the issue of separation of church and state was resolved. An essentialist reading of religion ignores the evolution of ideas and interpretations. The scriptural basis for the separation of the two realms is Jesus' famous saying: 'Then render unto Caesar what is due to Caesar, and render unto God what is due to God' (Matthew 22:21). But as was noted by Charles Butterworth, 'Not until sometime after Marsilius of Padua (c. 1275–1342) were Paul's strictures and the famous advice offered by Jesus about distinguishing between the things belonging to Caesar and those belonging to God raised to the elevated rank it occupies today.'[57]

In Islam the evolution was almost opposite. The early tradition as well as recent 'radical fundamentalist' movements do not distinguish the religious from the political realms. Yet historically, since the Umeyyad empire, some measure of secularization started appearing,[58] and over the centuries, the power of the Caliph became increasingly nominal. Olivier Carré has argued that the 'long tradition of Islam' was one characterized by some measure of separation of the two realms (though not by a Western-style secularism).[59] Only with the Islamic revival that started in the late eighteenth century and persists to this day, did Islamist regimes resort to the 'deviant orthodoxy' based on a return to the 'ideal' of Islam – that of Mohammed and the four 'rightly-guided caliphs'. It is Carré's hope that a return to this great tradition, which is commonly accepted by traditional Islamic jurisprudence in both Sunni and Shi'i doctrine could open the way to what he calls a 'post-Islamist Islam'.

This section and the historical and comparative discussions in Chapters 2 and 3 have shown that Islam, like other successful religions, has undergone significant change and proved capable of adjusting to evolving circumstances. In terms of the traditionalist/modernist dichotomy, traditionalist backlashes are possible in response to certain political, economic or financial developments, but they are likely to be short-lived. The long-term trend in Islamic finance is clearly towards increased pragmatism and the prevalence of modernist interpretations.

Notes

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3. See Chapter 4.
4. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*,

Paris: Presses Universitaires de France 1997, pp. 39–45.
5. Galloux, p. 46.
6. Ibid., p. 59.
7. Ibrahim Warde, ‘Comparing the Profitability of Islamic and Conventional Banks’, San Francisco: IBPC Working Papers 1997.
8. Galloux, p. 47.
9. Based on the saying of the Prophet: ‘My community will never agree on an error.’
10. *Majallat Majmaa al-Fiqh al-Islami.*
11. Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law*, London: Graham and Trotman 1995, p. 7.
12. Ray, p. 8.
13. See Chapter 6.
14. *Al-Ahram al-iqtissadi*, 3 March 1987.
15. Hamid Algabid, *Les banques islamiques*, Paris: Economica 1990, p. 126.
16. Daniel Brown, *Rethinking Tradition in Modern Islamic Thought*, Cambridge University Press 1996.
17. Koran 2:256 ‘There is no compulsion in religion – the right way is clearly distinct from error – So whoever disbelieves in the devil and believes in Allah, he indeed lays hold on the firmest handle which shall never break. And Allah is Hearing, Knowing’.
18. Koran 10:99 ‘And if thy Lord had pleased, all those who are in the earth would have believed, all of them. Wilt thou then force men till they are believers?’
19. Koran 60:8 ‘Allah forbids you not respecting those who fight you not for religion, nor drive you forth from your homes, that you show them kindness and deal with them justly. Surely Allah loves the doers of justice’.
20. Gudrun Kramer, ‘Islamist Notions of Democracy’, in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 77.
21. See Chapter 1.
22. Rodney Wilson, Economics, *Ethics and Religion: Jewish, Christian and Muslim Economic Thought*, New York University Press 1997, p. 115.
23. Ibrahim M. Abu Rabi‘, *Intellectual Origins of Islamic Resurgence in the Modern Arab World*, Albany: State University of New York Press 1996.
24. Seyyed Vali Reza Nasr, *Mawdudi and the Making of Islamic Revivalism*, Oxford University Press 1996.
25. John L. Esposito, *The Islamic Threat: Myth or Reality?*, Oxford University Press 1992, pp. 127–8.
26. Esposito, p. 134.
27. Bernard Lewis, *Islam and the West*, Oxford University Press 1993, p. 9.
28. See Chapter 6.
29. Stéphanie Parigi, *Des Banques Islamiques*, Paris: Ramsay 1989, p. 119.
30. Olivier Roy, *L’échec de l’islam politique*, Paris: Editions du Seuil 1992, p. 46.
31. Chibli Mallat, *The renewal of Islamic law: Muhammad Baqer as-Sadr, Najaf and the Shi’i International*, Cambridge University Press 1993, pp. 84–96.
32. Ira M. Lapidus, ‘The Golden Age: The Political Concepts of Islam’, in Charles E. Butterworth and I. William Zartman, *Political Islam, The Annals of the American Academy of Political and Social Science*, November 1992, p. 17.
33. Ibid.
34. Roy, pp. 10, 42 and 56.
35. With the spread of coffee-drinking in the seventeenth century, the ulema almost unanimously took the view that coffee-drinking was unlawful and punishable with the same penalties as wine-drinking. This even resulted in

some executions. But the prohibition was ignored and the ulema eventually gave up the fight. See Edward, *Faith and Power: The Politics of Islam*, New York: Random House 1982, p. 98.
36. Mortimer, p. 123.
37. Roy, p. 45.
38. Lisa Anderson, 'Tunisia and Libya: Responses to the Islamic Impulse', in John L. Esposito (ed.), *The Iranian Revolution: Its Global Impact*, Florida International University Press 1990, p. 171.
39. Lisa Anderson, 'Qaddafi's Islam', in John L. Esposito (ed.), *Voices of Resurgent Islam*, Oxford University Press 1983, p. 143.
40. Ann Elizabeth Mayer, 'In Search of Sacred Law: The Meandering Course of Qaddafi's Legal Policy', in Dirk Vandewalle (ed.), *Qaddhafi's Libya*, 1969–1994, New York: St Martin's Press 1995.
41. Judith Miller, *God Has Ninety-Nine Names: A Reporter's Journey Through a Militant Middle East*, New York: Simon and Schuster 1996, p. 162.
42. Ibrahim A. Karawan, 'Monarchs, Mullas, and Marshals: Islamic Regimes?', in Charles E. Butterworth and I. William Zartman, *Political Islam, The Annals of the American Academy of Political and Social Science*, November 1992, p. 115.
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44. Mumtaz Ahmad, 'Pakistan', in Shireen Hunter (ed.), *The Politics of Islamic Revivalism*, Indiana University Press 1988, p. 231.
45. Karawan, p. 107.
46. Samuel P. Huntington, *The Clash of Civilizations and the Remaking of World Order*, New York: Simon and Schuster 1996, p. 70.
47. Lewis, p. 135.
48. Ibid.
49. Letter to the Romans, 13:1–2 and 13:14.
50. Esposito, p. 186.
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52. Muhammad Said Al-Ashmawi, *L'Islamisme contre l'Islam*, Paris: La Découverte 1989.
53. Nimat Hafez Barazangi, M. Raquibuz Zaman and Omar Afzal (eds), *Islamic Identity and the Struggle for Justice*, Gainesville: University Press of Florida 1996, pp. 69–71.
54. Mortimer, p. 137.
55. Olivier Carré, *L'Islam laïque ou le retour à la Grande Tradition*, Paris: Armand Colin 1993, p. 51.
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57. Charles E. Butterworth, 'Political Islam: The Origins', in Charles E. Butterworth and I. William Zartman, *Political Islam, The Annals of the American Academy of Political and Social Science*, November 1992, p. 27.
58. See Chapter 2.
59. Carré, 1993.

CONCLUSION

Any objective assessment of Islamic finance can only be mixed. Islamic finance is a success, considering that it is no longer an uncertain experiment, but a reality: it is now a $200 billion industry that is likely to keep growing at a rapid clip as the 'money revolution' continues, and as more countries authorize and even encourage the creation of Islamic institutions.

But it is also a failure insofar as it did not fulfil its original promise of becoming an original and innovative system, based on risk sharing, that would bring social and economic benefits to the Islamic world. Indeed, profit-and-loss sharing (PLS) transactions, initially the raison d'être of the industry, only account for about five per cent of the operations of Islamic financial institutions. Most now prefer to engage in trade finance and mark-up activities. Such modes of financing, while accepted by Islamic scholars – albeit without great enthusiasm – do not bring significant social and economic benefits to the community, and tend to mirror conventional finance. Even the promise of interest-free finance has not been fulfilled, since interest-like mechanisms have been devised, and since many Islamic institutions have been deriving substantial income from interest-bearing balances in foreign banks. More ominously, scandals and other problems have plagued a number of institutions, raising serious ethical and religious issues.

By not embarking on a path of true financial innovation, Islamic institutions raise the inevitable question: is Islamic finance necessary? Arguably it is, since it can still fulfil its original objectives. And at a time when Islamic countries are overhauling their regulatory systems and entering the global economy, it can provide a much-needed ethical framework as well as useful correctives to the excesses of contemporary finance.

The gap between promise and performance can be attributed to the youth of the industry. Islamic finance only came into existence in the 1970s, and it would be unfair to judge it severely, since many venerable institutions have not proved, in today's financial jungle, to be exemplars either of probity or of financial success. From that perspective, many of the shortcomings of Islamic finance can be looked at as unavoidable growing pains – part of the trial-and-error process that may yet lead to the fulfilment of original goals.

In the early years of Islamic finance, mark-up operations and other religiously neutral transactions were seen as desirable only to the extent that they would ensure the financial viability of the first Islamic banks. Such short-term, low-risk financing mechanisms would provide them with the necessary resources to grow, establish themselves, and expand throughout the Islamic world. The danger today is that mechanisms that were once intended to be provisional have become institutionalized, causing more desirable and more authentic financing modes to fall by the wayside. The way in which many institutions responded to their initial forays into profit-and-loss sharing is in that respect revealing. Rather than learning from their mistakes, they decided to abandon such operations altogether. A more fruitful approach would of course have been to undertake an improvement of procedures.

But any quest for solutions can only begin with a clear assessment of the problem. And this is one of the many areas where the literature on Islamic finance can be found wanting. By insisting on painting a rosy picture (or by simply wallowing in abstraction and irrelevance), researchers did a disservice to Islamic financial institutions; they encouraged the perpetuation of the status quo, and prevented the kind of research that would have fulfilled the original aims of the industry.

This book has attempted to unveil a more complete picture of Islamic finance by presenting its many facets, by placing it in the context of the global economy, and by exploring it from empirical, comparative and historical perspectives. The agenda for future research is daunting and includes topics that many analysts, steeped in literal and legalistic interpretations, have shunned. Yet identifying the moral economy, and addressing issues of culture, Islamic moral hazard, etc., is more useful than parsing medieval contracts, or engaging in irrelevant apologetics. This book has sought to address such issues and introduce heretofore neglected areas in the hope that it will stimulate the kind of research that will be relevant in the global economy.

GLOSSARY

Adl: justice.
Alim (pl. **ulema**): learned man or religious scholar.
Al-wadia: safekeeping.
Awqaf (sing. **waqf**): religious endowments.
Ayatollah: honorific title given to leading Shia clerics in Iran (literally, 'sign of God').
Bay muajjal: deferred-payment sale.
Bay salam: pre-paid purchase.
Bidaa: innovation.
Daawa: missionary activities (literally, 'call').
Darura: overriding necessity.
Faqih (pl. **fuqaha**): jurist, expert in Islamic law.
Fatwa: legal opinion, religious edict.
Fiqh: jurisprudence.
Fuqaha: see faqih.
Gharar: deception, hazard, speculation, uncertainty, risk (literally, peril or hazard)
Ghosh: fraud.
Hadith: stories about and sayings (specific pronouncements, deeds, or approvals of other people's actions) of the Prophet.
Haj: pilgrimage.
Haja: necessity.
Halal: lawful or permissible (see haram).
Haram: unlawful or forbidden (see halal)
Hisbah: an office which in traditional Islam supervised markets, provided municipal services and settled petty disputes.
Hiyal: (sing. **hila**): ruses, used in reference to crafty ways of circumventing the prohibition of riba.
Hudud: punishments such as dismemberment and death by stoning.
Ijara: leasing.
Ijmaa: consensus.
Ijtihad: devout and careful reflection and effort; use of independent judgment or original thinking in interpreting the Koran and the Sunna.
Infitah: open-door policy pursued by Anwar Sadat in the early 1970s.
Islah: reform.
Israf wa taraf: luxury activities; profligacy.
Istisna: commissioned manufacture.
Jahiliyya: pre-Islamic era (literally, state or age of ignorance).
Jahl: ignorance, or lack of knowledge.

Jihad: holy war or spiritual exertion.
Koran: Islam's holy book.
Madhab: school of religious and moral interpretation.
Manfaa: usufruct.
Maslaha: the general interest.
Maysir: a game of chance condemned by the Koran.
Mudaraba: trustee finance, or commenda partnership.
Mudarib: managing trustee.
Mufti: chief religious cleric, usually government-appointed.
Muqarada: loan participation.
Murabaha: contract whereby a financial institution buys goods or commodities on behalf of a borrower and then sells it on a deferred basis at a mark-up.
Musharaka: joint venture between a financier and an entrepreneur.
Qadi: judge.
Qard hasan: interest-free loan usually given for charitable purposes (literally, 'good loan').
Qirad: see mudaraba.
Qiyas: reasoning by analogy or by logical inference.
Rabb al-mal: beneficial owner or sleeping partner.
Riba: interest or usury (literally, increase or addition).
Sadaqa: pious work of charity.
Salaf: the 'pious ancestors', usually includes the Prophet Mohammed and the first four 'rightly guided' caliphs.
Salam: advance purchase.
Salat: prayer.
Shahada: proclamation of faith.
Shariah: Islamic law.
Shirka: see musharaka.
Shura: consultation by the ruler of the community notables.
Sunna: practices and rulings deduced from the deeds, utterances and unspoken approvals of the Prophet and his companions.
Tajdid: renewal.
Takaful: mutual guarantee.
Taqlid: imitation.
Ulema (sing. **alim**): learned men or religious scholars.
Umma: community of believers or nation of Islam.
Urf: custom
Usul el fiqh: principles of Islamic jurisprudence.
Waqf (pl. **awkaf**): charitable trusts; property endowed to Islam for the benefit of Muslims.
Zakat: voluntary almsgiving (literally, 'purification')

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